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A MARKET-ORIENTED PETROLEUM INDUSTRY AS A PREREQUISITE TO RUSSIAN ECONOMIC SECURITY

by

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The Russian petroleum industry is facing a critical juncture where expedient reform is necessary immediately. The main focus of this thesis is to account for the primary barriers which hamper the free flow of former Soviet petroleum into international markets and to suggest alternatives to current Russian energy policy. A secondary objective is to scrutinize the United States' foreign policy with respect to the possibility of influencing the augmentation of world petroleum supplies. Preliminary indications suggest that confidence-building measures have been slowly introduced by the Yeltsin administration, but the positive effects have not yet been felt by the petroleum industry. International investment within the Russian petroleum industry has been sluggish at best. Transnational oil companies continue to be reluctant to invest in Russia and the former Soviet Union due to political and economic uncertainty and the high risk of capital loss. The future of the Russian petroleum industry appears promising provided the major barriers (e.g., tax codes, presidential decrees, pipeline construction and maintenance, and capital investment) are directly confronted and not circumvented for political leverage or corrupt economic gains.

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A MARKET-ORIENTED PETROLEUM INDUSTRY AS A PREREQUISITE TO RUSSIAN ECONOMIC SECURITY

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ABSTRACT

The Russian petroleum industry is facing a critical juncture where expedient reform is necessary immediately. The main focus of this thesis is to account for the primary barriers which hamper the free flow of former Soviet petroleum into international markets and to suggest alternatives to current Russian energy policy. A secondary objective is to scrutinize the United States' foreign policy with respect to the possibility of influencing the augmentation of world petroleum supplies. Preliminary indications suggest that confidence-building measures have been slowly introduced by the Yeltsin administration, but the positive effects have not yet been felt by the petroleum industry. International investment within the Russian petroleum industry has been sluggish at best. Transnational oil companies continue to be reluctant to invest in Russia and the former Soviet Union due to political and economic uncertainty and the high risk of capital loss. The future of the Russian petroleum industry appears promising provided the major barriers (e.g., tax codes, presidential decrees, pipeline construction and maintenance, and capital investment) are directly confronted and not circumvented for political leverage or corrupt economic gains.

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I. INTRODUCTION

The current lack of former Soviet oil and gas revenues preclude economic security without the solvency of various barriers which impede interstate and international trade. The Russian political bureaucracy is at odds with the newly independent states over petroleum rights and the persistence by transnational oil corporations to exploit the massive known reserves outside of the Russian Federation. In addition, the process of gaining international oil contracts has been sluggish due to unfair tax codes, revenue-sharing disparities, continuing deterioration of interstate relations, and the high cost of initial capital for drilling and infrastructure (oil transport and pipeline construction).[1]

The confidence-building mechanisms necessary for economic opportunity are lacking throughout the former Soviet Union (FSU). The oil-producing states of the FSU demand independent markets and international assistance without Moscow's bureaucratic intervention. Revenues from oil and gas are the single most important resource or commodity which has prevented the collapse of the Russian economy since the demise of the Soviet Union. Currently, oil accounts for 60 percent of all Russian export revenues.[2] The former Soviet oil-producing states need revenues

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[1]Bill Javetski, "Why Soviet Oil Wells Won't Be Gushing Soon", Business Week, September 9, 1991, 36-38.

[2]Howard Banks, "The Land of a Thousand Leaks", Forbes, July 8, 1991, 35.

for continued independence and to supplant Russian economic influence. I consider Moscow's control of oil revenues as a key economic indicator of the future success or the continued deterioration of the state.

In this thesis, details which hinder economic growth within the former Soviet Union will be examined relative to oil production and consumption along with those details which permit Russia to exploit their neighbors for national benefit. The objective of this thesis is to account for a number of the major barriers which hamper the free flow of former Soviet oil into international markets and to suggest alternatives to Russian energy policy. A secondary objective is to examine a progressive U.S. foreign policy capable of augmenting world petroleum supplies (with an emphasis on Russian petroleum exports). The current situation requires the utmost scrutiny by the United States and the introduction of measures for the continued peace and economic security of the post-communist states of the Soviet Union[3].

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[3]Note: Throughout this thesis the terms FSU and former Soviet Union will be used interchangeably to refer to that entity or geographical area that existed after August 1991 which consists of the former boundaries of the USSR. This entity has no political, economic, or military empowerment or decision authority. It refers only to a geographical region. The CIS (Commonwealth of Independent States) will refer to the federation of independent states within the FSU starting in 1991 (excluding the Baltic states and Moldova) which work together under common rules of government but have independent governmental bodies. USSR and Soviet Union will refer to the political, economic, and military state which existed between 1917-1991. The use of the term Russia will refer to the state prior to 1917 or the Russian Federation from 1991 to the present.

II. RUSSIAN PETROLEUM SINCE THE DEMISE OF THE SOVIET UNION

A. OIL AND GAS CONSUMPTION, PRODUCTION, AND RESERVES

The petroleum industry in Russia and the other former Soviet states is in a critical state. The problems resulting with the decline of this industry can be attributed to many factors, but the most significant is the lack of production and exploration which ensures invaluable monetary resources for a declining economy. The Soviet Union was the world's leading petroleum producer as little as six years ago with nearly 12.5 million barrels of oil produced per day. Today, that figure is less than 7.0 million barrels per day[4]. When taking into consideration that over 60 percent of all Russian export revenues in 1995 are attributed to the sale of petroleum and petroleum products, it is apparent that the Russian economy is dependent upon the international market for survival. The fall in the Russian Federation's petroleum production is greater than the production of any OPEC country with the exception of Saudi Arabia. The magnitude of this crisis (almost 50 percent decline in petroleum production) is far greater than any petroleum analysts ever anticipated. Russia along with the other former Soviet states can and must return its crude and condensate production to 12 - 12.5 million barrels per day. This will only be possible through

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[4]Daniel Yergin and Thane Gustafson, Russia 2010: And What it Means for the World (New York: Random House, 1993), p. 245.

improved management and hard currency investment within the petroleum sector.

In order to understand the significance of the major changes in world production and consumption, statistics must be analyzed from the late 1980's up to the present day. The comparative decline in production and the increase in consumption for most major industrial nations would appear to be setting a trend of increasing dependence on third world petroleum reserves. For the following analysis, I will mainly focus on oil since it still accounts for three-quarters of the total volume of world trade in energy[5]. Initially though, a brief historical account of the Soviet Union's oil industry may help to shed light and better understand what may lie ahead.

At the turn of the century, Russia was the leading oil producer in the world, accounting for half of the world total. By 1921, production had fallen to 30 percent of the peak set in 1901. The decline was triggered by labor disputes and armed uprisings in the Baku region. A similar situation exists today, but now triggered by ethnic conflict.

Prior to the Bolshevik Revolution in 1917, Western oil interest in Russia was considerable. On June 1, 1918, the oil industry was nationalized and all of the Western interests were expropriated. Baku fell back into the hands of Turkey in 1920. The Bolshevik forces, victorious in the civil war, regained

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[5]J.E. Hartshorn, Oil Trade: Politics and Prospects (Cambridge, MA: Cambridge University Press, 1993), p. 35.

control of Baku and once again the oil properties were nationalized without indemnification.

With nationalization, the history of the czarist oil industry was now at a close. The oil industry remained socialized, the state took on decisions that once were the prerogative of the private businessman. From that time forward, the Soviet oil industry moved along lines dictated by successive five-year plans. Supply exceeded demand in the years running up to the beginning of World War II. As a percentage of oil production, oil exports in the mid-1920's to the mid-1930's were comparable to those percentages of the 1970's and 1980's.

Production fell dramatically during World War II, as a result of the enemy occupation and the transfer to the east of prospecting and drilling crews. The shift eastward proved successful with the discovery of the Urals-Volga oil fields, which carried the country, in terms of oil supply, through the 1960's. By that time, substantially richer finds had been discovered in the inhospitable lands of Western Siberia.

The explosion in oil production, as the new West Siberian oil fields came on stream, was unmatched by those of Baku. Between 1970 and 1980, Soviet production rose by more than 5 million barrels per day. The export of oil grew concomitantly from some 1.9 million barrels per day in 1970 to 3.3 million barrels per day by 1980. More significantly, hard currency earnings from such exports expanded much faster, from less than $390 million in 1970 to in excess of $12.1 billion in 1980. This

obviously reflects the sharp jump in world prices emerging from the 1973-74 oil crisis.

The Central Intelligence Agency prepared a report for President Carter entitled The International Energy Situation: Outlook to 1985 which was released in April 1977. This particular report foresaw world oil demand substantially exceeding supply by 1985. Prices would rise sharply in order to distribute available supplies. All this would take place if energy conservation were not greatly increased. A section of this report concluded that the Soviet Union would find itself not only unable to supply oil to Eastern Europe and the West on the then present scale but also having to compete for OPEC oil for its own use.

What was the rational grasped by the CIA in 1977 behind declining Soviet oil production? It was much the same then as it is now: the failure to find and develop new oil fields to replace declining production at mature areas; emphasis on developmental drilling at the expense of exploration drilling; and water incursion of the production wells. It was concluded that the initial falloff, when it comes, would almost certainly be sharp and may continue to fall sharply. This has occurred, but it has been ten years later than expected.

The current loss in Russian oil export capability may be mitigated in part by lower domestic requirements. The reduction of economic activity has brought about considerably higher prices for fuels; the downward trend will continue until international

investment is sought within all economic sectors. Why should we continually speculate about the ability of the former Soviet Union to export oil? First, we care about the level of former Soviet oil exports because further declines in such exports will give OPEC more direct control over the world oil market. Secondly, the former Soviet Union must be able to earn hard currency if it is to meet its foreign debt obligations, and to present some semblance of credit-worthiness to bankers and foreign governments. Thirdly, the development of sources of oil outside the United States and away from the Persian Gulf would be responsive to one of the major elements of our National Energy Strategy. It is for these reasons that the U.S. made the judgement (in our National Energy Strategy) that a healthy Russian oil and gas industry is in our longer-term political and economic interests[6].

What has gone wrong with the Russian oil industry? New wells stand idle because shortages of steel pipe have prevented the construction of oil gathering systems. Older wells have been shut down for lack of spare parts. Pipelines burst because of initial poor construction practices and because regular inspection is being ignored. Water is overwhelming the producing fields. Oil refineries are badly outmoded by Western standards, lagging perhaps 15 years or so in terms of technical innovation.

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[6]Hazel R. O'Leary, Department of Energy Strategic Plan, April 1994, p. 16.

New oil discoveries are small in size and fall far short of replenishing oil supplies.

Should world demand grow along anticipated lines and if Iraqi oil remains off the market, the continued collapse of the Soviet oil industry and the parallel withdrawal of its oil from the world market will test OPEC. Indeed, it may be considered that certain OPEC member-countries are planning for just that circumstance, as they work to expand producing capacity and to market increased volumes in their search for additional income.

Constraints in domestic oil supply raises the prospect that those newly independent states, such as the Baltics and the Ukraine, all heavily dependent on imports to fuel their economies, may increasingly turn to suppliers in the Middle East. It is likely that some Middle East oil will flow to these consumers, but Russia will most likely remain the dominant supplier.

We now have to consider, in the context of energy supply and demand, the meaning of Ukrainian independence. Because export oil and gas pipelines transit the Ukraine enroute from Russia to Eastern and Western Europe, that places a powerful weapon in the hands of the Ukrainians. That weapon (closure of the pipelines) need never be used, but the potential impact of its use is always there. Think what closure of these lines, for perhaps political purposes, might mean for Russia, for Eastern and Western Europe, and for world oil prices.

The division of socialist labor in the Soviet Union meant that one republic (Azerbaidzhan) would concentrate on the manufacture of oil field equipment, while another (Uzbekistan) would be the center for the growing of cotton. Thus, no one republic truly was economically independent, although the Russian Republic came the closest simply because of its geographic size and diversity. What will this mean in terms of equipment availability, labor, and technical expertise for the oil industry?

This division of labor did not work well at all under the old regime; and because it did not, the fragmentation of the former Soviet Union will not hold the adverse conditions it might, had the situation been otherwise. Indeed, if anything, it may well cause the former republics to recognize that they need one another as much now as they did before[7].

If your own means are limited, as they are for the former Soviet Union, then the natural recourse would be to look abroad for help; thus, the rational for joint ventures. Joint ventures offered to date generally involve the development of known but complex oil deposit recovery, a task which presently is beyond the host country's capability; or a joint venture may involve the rehabilitation of a producing field through horizontal drilling

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[7]An historical account transcribed from a hearing before the Subcommittee on Energy and Power during the first session of the 102nd Congress(HR), December 11, 1991. Mr. Robert E. Ebel, Vice President, International Affairs Ensearch Corporation was the speaker. The subject matter included oil and the former Soviet Union, pp. 50-56.

or work-overs, or through the application of secondary and tertiary recovery methods.

Presuming the removal of all obstacles, permitting the broad involvement both sides seek, would successful joint ventures with Western oil companies allow the Soviet oil industry to halt its decline, and return to previous output and export levels? With the U.S. becoming less attractive for exploration, exploration dollars are flowing overseas in greater numbers. In the 1980s these dollars found their way to China, but with little success in terms of volumes of oil found. Now, these dollars are pointing their way towards the former Soviet Union. Yet, just some 50 joint ventures have been registered in the oil industry to date, of which 16 are functioning. But only two joint ventures have actually reached the stage where crude oil has become available to the foreign partner for export, (Tengiz Field exploited by Chevron and Volgograd Fields exploited by Nationale Elf Aquitaine from France). Why the delay? If the oil companies are wanted and needed by the former Soviet oil-producing states, and if the companies in turn are anxious to get going, then something must be wrong. Indeed, there is a problem.

In July 1993, those major U.S. oil companies interested in doing business in the former Soviet Union participated in a U.S.-Russia Energy Roundtable, held in Moscow[8]. The purpose of the Energy Roundtable was to clarify those obstacles which, in the

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[8]Stephen Blank, Energy and Secuity in Transcaucasia (Carlisle Barracks, PA: Strategic Studies Institute, Army War College), September 7, 1994, pp. 23-42.

minds of the oil companies present, precluded them from going ahead with plans to invest. Strong reference was made to the need that the rate of return should be commensurate with the risks and difficulties involved, and be competitive with other opportunities elsewhere in the world.

Taxes were too high and complicated. Multiple forms of business structures were desirable, as each investor and each project has a different need. The right to freely export at market prices and retain proceeds of sales and profits abroad were critical. Internal sales should be made at international market prices, with remuneration in convertible currency. But this listing omitted one very key concern: who are the real decision-makers in the Russian Federation? That concern still exists. The same conundrum faces the U.S. government: with whom to negotiate, to sign treaties, to carry on those working relationships normally expected between sovereign states?

Much has been said as to what actions Russia must take, if it is to attract Western investment. Above all, there must be in place a comprehensive legal framework covering business activity. The currency must be convertible. A sound financial system is also a necessity. And wrapped around all this, there must be the cloak of stability.

The role of the U.S. in helping foster an acceptable investment climate in the former Soviet Union is quite limited. The burden rests with the Russian side, and will continue to do so. Oil companies are accustomed to operating in sometimes

hostile political and economic environments. For the companies, it is not a matter of risk identification. That is the easy part. Rather, the difficulty rests with risk management. Clearly, then, given the unsettled political and economic conditions now extant, the prospect of successful risk management becomes more uncertain.

I would not anticipate any substantial impact from joint ventures on domestic supply until 1997 or so. Under a majority of the joint ventures, half the oil belongs to the foreign partner, and will contribute nothing to meeting domestic requirements or to export capability.

The USSR historically suffered from local fuel shortages, especially during the harvest season, for two reasons. First, the distribution network was antiquated and could not cope with rising demand. Second, the yield of light petroleum products such as gasoline, jet fuel and diesel fuel from Soviet refineries (at 62 percent capacity), is much too low by modern standards. Now, however, a more precarious element has entered the picture. The former republics will be looking out for their own interests first, in the absence of a strong center. With shortages and rationing the order of the day, inter-state trade in fuel and energy has become politicized. That means fuel deliveries, for example, can be withheld as a form of blackmail to induce another former republic to act in a way responsive to the desires of the seller. That is happening today on a broadening scale. One example comes immediately to mind. The delivery of natural gas

from Azerbaidzhan to Armenia has been stopped because of ethnic disputes[9].

The disappearance of a strong center, an unprecedented collapse of political and economic institutions, with no hope for any early resuscitation - all make for a potentially very dangerous situation. Oil cannot be separated from this equation. Russia, which controls some 92 percent of oil production and refining of the former Soviet Union, most likely will be inclined to take advantage of its position when and where it can. FSU oil-producing states, where the fuels and energy industries may stand on the brink of collapse, understandably become nervous, because both their political and economic postures then become vulnerable. Decisions taken will reflect that uneasiness, and the need to erase that vulnerability.

The following statistics gives credence to the ever-changing international petroleum market. The changes in oil and gas production between 1989 and 1995 will be my focus since the dramatic changes to USSR, the former Soviet Union, and the United States with reference to petroleum production and consumption occurred during this time frame. The major oil producers in 1989 according to million barrels of oil produced per day (mbd) were: (in descending order) (1) USSR, 12.60 mbd; (2) United States, 8.70 mbd; (3) Saudi Arabia, 5.10 mbd; (4) Iran, 2.84 mbd; and (5) Mexico, 2.82 mbd. These five countries accounted for almost 60 percent of all oil produced in the world (of which OPEC produced

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[9]Blank, pp. 40-45.

34 percent of the world total) [see Table 1][10]. The world order today with respect to oil production has changed dramatically for only a five year period. The following countries were the major producers for calendar year 1994: (1) Saudi Arabia, 8.00 mbd; (2) Commonwealth of Independent States, 7.03 mbd (of which Russia produced 6.60 mbd); (3) United States, 6.63 mbd; (4) Iran, 3.59 mbd; and (5) China, 2.98 mbd [see Table 2]. These top five oil-producing countries accounted for 46 percent of the world total; a significant decrease from the figure given in 1989. While OPEC countries accounted for 34 percent of world oil production in 1989, today they account for 40.80 percent of the world total. The rate of dependency upon OPEC for a majority of the oil reserves is quite apparent; and it should be alarming to those countries that depend on a majority of oil from the international market (e.g., the United States receives 40 percent of imported oil from OPEC, South East Asia receives almost 75 percent of its oil from Middle East OPEC countries)[11].

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[10]J.E. Hartshorn, Oil Trade: Politics and Prospects (Cambridge, MA: Cambridge University Press, 1993), p. 38.

[11]Oil and Gas Journal, March 13, 1995, pp. 61 and 210.

TABLE 1. OIL PRODUCTION 1989

COUNTRY	PRODUCTION (mbd)	% OF WORLD PRODUCTION
USSR	12.60	23.44%
United States	8.70	16.18%
Saudi Arabia	5.10	9.49%
Iran	2.84	5.28%
Mexico	2.82	5.25%
OPEC	18.28	34.00%
WORLD TOTAL	**53.76**	**100.00%**

TABLE 2. OIL PRODUCTION 1994

COUNTRY	PRODUCTION (mbd)	% OF WORLD PRODUCTION
Saudi Arabia	8.00	13.04%
CIS (Russia)	7.03 (6.60)	11.46% (10.75%)
United States	6.63	10.80%
Iran	3.59	5.85%
China	2.98	4.86%
OPEC	25.04	40.80%
WORLD TOTAL	**61.37**	**100.00%**

The demand by OECD (Organization for Economic Co-operation and Development) countries for oil has increased anywhere from 2.0 percent to 4.0 percent each year since 1989. This trend appears to be the norm for the next few years. Contrary to this trend, non-OECD countries have decreased demand and supply by almost the same percentage, but the former Soviet Union accounts for the major decline (50 percent) in supply and demand [(FSU demand: 4.61 mbd; supply: 6.91 mbd; (1995 figures)]. Even though the FSU has had almost a 50 percent decline in production and consumption during this same period, the effects on the international markets has been negligible due to Russia's ability to continue exports at former levels. The major concern within the international arena is the increasing dependency on OPEC oil as the prime source for OECD imports. The U.S. does not necessarily depend on any specific region for oil, but we are concerned very much over the petroleum dependency for our strategic allies. These countries (e.g., Japan, France, Italy, United Kingdom, etc.) import a majority of their oil from OPEC and specifically the Middle East[12]. Any disruption of oil flow out of the Middle East could create a panic of world proportions. This also explains a great deal about U.S. military presence in this region.

The top five natural gas producers in the world from 1989 to 1995 have not changed in order (according to total production). They are as follows in terms of billion cubic feet (bcf)

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[12]Oil and Gas Journal, March 27, 1995, p. 61.

produced: (1) Commonwealth of Independent States, 25,674 bcf (of which Russia accounts for 21, 823 bcf); (2) United States, 19,822 bcf; (3) Canada, 5,855 bcf; (4) Netherlands, 2,772 bcf; and (5) United Kingdom, 2,540 bcf. These countries accounted for 73.5 percent of the total world production. The breakdown of world production percentages is as follows: (1) CIS, 33.30 percent; (2) U.S., 25.70 percent; (3) Canada, 7.60 percent; (4) Netherlands, 3.60 percent; and (5) United Kingdom, 3.30 percent. All of these countries, except for the CIS, consumed almost their entire domestic production totals. The CIS exported almost 40 percent to Western Europe [see Table 3][13].

Each respective country has increased production output of 3 percent on average during the past six years. Conversely, oil production for the United States and the CIS has decreased by 23 percent and 44 percent respectively. It is quite evident that the relationship between oil and gas production, if it exists, has either affected the reversal production and consumption trend of one upon the other; or there is no relationship. I would theorize that there is no relationship since consumption of oil versus gas has not changed irrespective of production ratios.

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[13]Natural gas figures utilized or interpreted from Oil and Gas Journal Statistics of March 14, 1994, p. 87 and March 13, 1995, p. 110.

TABLE 3. NATURAL GAS PRODUCTION 1995

COUNTRY	PRODUCTION (bcf)	% OF WORLD PRODUCTION
CIS (Russia)	25,674 (21,823)	33.30% (28.31%)
United States	19,822	25.70%
Canada	5,855	7.60%
Netherlands	2,772	3.60%
United Kingdom	2,540	3.30%
OPEC	31,048	40.27%
WORLD TOTAL	**77,099**	**100.00%**

The impact of gas upon petroleum markets and international trade is increasing for the same reasons that it did much earlier for oil: demand growth in traditional consuming areas and new demand in emergent markets, both increasingly separated geographically from the main sources of supply. The world energy consumption in the last twenty years has increased by 38 percent. Surprisingly, estimated reserves and actual reserves had also increased by a similar percentage. Among fossil fuels during this period, natural gas has been the most dynamic energy source, with a growth of 65 percent versus 12 percent for oil and 28 percent for coal. In terms of market share, natural gas has grown from 19 percent to 23 percent in the past twenty years,

while oil has declined from 49 percent to 40 percent, and coal from 30 percent to 27 percent.

The change within the consumer market cannot be compared to the actual reserves since world coal reserves are equal to 67 percent of total fossil fuels, while oil reserves amount to 17 percent and gas reserves 16 percent. Due to the lesser impact of gas exports upon the international markets, the reference to gas will be mainly the subject for analyzing the export potential for former Soviet Union gas reserves. Natural gas, unlike oil, is heading in a positive direction for most OECD countries. Due to the fact that the main producers are also the main consumers within OECD countries (with the exception of Japan and Germany), the control of natural gas (or "the power factor") is negligible within the international market. The lack of export potential of Russian natural gas greatly affects the CIS's economic outlook and ultimately affects the primary importers of Eastern and Western Europe.

The six year decline in oil production within the former Soviet Union will have dire consequences unless the trend is stopped. While current reserves are being exhausted, new reserves are not being prepared for production fast enough. During the 1980's the Soviet Union on average had shut-in 2-4 percent of their wells. Today almost 31 percent of the wells are idle. As mentioned earlier, the lack of spending on exploration and the opening of new wells has hampered the Russian petroleum industry to the point of possible economic collapse. More than

70 percent of today's explored (proved plus probable) oil reserves are under development. There is no sign of surplus reserves without technological assistance from the West (primarily the U.S.). The curtailment of geological exploration on grounds that there is a lack of money will have a disastrous effect on oil production as far into the future as 1996-2000. According to the Oil and Gas Journal, it is time for the former Soviet Union to set aside revenues from the levy on oil and gas prices into a special account to finance geological exploration[14]. Due to the disestablishment of the Soviet geological ministry, revenues could be disbursed to other countries with the technological capability for enhanced recovery, advanced geological equipment, and horizontal drilling capabilities, but this is not the situation.

Production figures for oil and gas are extremely significant if the only consideration is how much oil and gas is on the international market at a given point; and who is consuming the majority of the oil and gas at any given time frame? More importantly though, which country or countries have the most proven or probable petroleum reserves? This will indicate the potential for longevity within the petroleum market. Some countries (e.g. the United States) produce a substantial amount of oil and gas (10.80 percent and 25.70 percent respectively in the world) but only account for a small proportion of the

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[14]Domenico Dispenza, Oil and Gas Journal, May 4, 1992, pp. 44-45.

reserves (U.S. possesses 2.40 percent of the world oil reserves and 3.30 percent of the world natural gas reserves).

The top five oil reserves countries in the world are: (1) Saudi Arabia with 258.70 billion barrels accounts for 25.90 percent of the world total and 33.50 percent of OPEC total reserves; (2) Iraq with 100.00 billion barrels accounts for 10.00 percent of the world reserves; (3) Kuwait with 94.00 billion barrels accounts for 9.41 percent of world reserves; (4) Iran with 92.80 billion barrels accounts for 9.30 percent of world reserves; and (5) Abu Dhabi with 92.20 billion barrels accounts for 9.23 percent of world reserves. These five countries account for 63.80 percent of the total world oil reserves (999.00 billion barrels is total world oil reserves in 1995). OPEC accounts for 77.30 percent of the total world oil reserves [see Table 4][15].

Natural gas reserves like oil reserves are also concentrated in particular regions. The major problem with the exploitation of these reserves (with reference to the former Soviet Union) is the lack of a transportation network designed to reach international markets. Natural gas is slowly but surely supplanting the exports of oil. The wealth of petroleum within Russia and the former Soviet republics (natural gas accounting for 40 percent of the total world reserves) has the potential for creating a huge impact upon the international markets if oil reserves continue to be depleted at current rates. Various

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[15]"Worldwide Look at Reserves and Production", Oil and Gas Journal, December 13, 1994, pp. 94-95.

geological services have estimated that oil reserves could be depleted as early as 40-45 years from now (these estimates could be conservative since many undiscovered reserves still exist).

TABLE 4. OIL RESERVES

COUNTRY	RESERVES (billions barrels)	% OF WORLD RESERVES
Saudi Arabia	258.70	25.90%
Iraq	100.00	10.00%
Kuwait	94.00	9.41%
Iran	92.80	9.30%
Abu Dhabi	92.20	9.23%
OPEC	772.23	77.30%
WORLD TOTAL	**999.00**	**100.00%**

The top five natural gas reserve countries in the world are as follows: (1) Commonwealth of Independent States, 1,997,000 billion cubic feet (bcf) which accounts for 39.80 percent of the total world reserves, of which Russia accounts for 85 percent; (2) Iran, 730,000 bcf which accounts for 14.60 percent of the total world reserves; (3) Qatar, 250,000 bcf which accounts for 5.00 percent of the total world reserves; (4) Saudi Arabia, 185,360 bcf which accounts for 3.70 percent of the total world reserves; and (5) United States, 164,015 bcf which accounts for

3.30 percent of total world reserves. Unlike oil reserves, OPEC accounts for only 40.00 percent of all natural gas reserves which is still considerable by international standards [see Table 5][16].

TABLE 5. NATURAL GAS RESERVES

COUNTRY	RESERVES (bcf)	% OF WORLD RESERVES
CIS (Russia)	1,997,000 (1,697,450)	39.80% (33.84%)
Iran	730,000	14.60%
Qatar	250,000	5.00%
Saudi Arabia	185,360	3.70%
United States	164,015	3.30%
OPEC	2,020,448	40.00%
WORLD TOTAL	**5,016,213**	**100.00%**

Natural gas reserves are neither concentrated into any one region, nor are they as geographically removed from patterns of consumption, as those of oil. According to the aforemention figures on oil and gas production, consumption, and reserves, the anticipation of a correlation between total production of a given country and its reserves is many times just a fallacy which can only be explained through an analysis of supply and demand. The

[16]"Worldwide Look at Reserves and Production", Oil and Gas Journal, December 13, 1994, pp. 94-95.

degree of concentration of supply and demand are quite similar. The main consumers and producers (top 6 oil and gas producing countries) account for over half of each world total. These cores of demand and supply overlap, mainly because the U.S. and former Soviet Union were, until 1990, the world's largest oil consuming and producing countries. The geographical dispersion of demand and supply outside the U.S. and USSR, in the postwar decades, was what generated most of the international oil trade.

Today, neither country is isolated from this trade. The U.S. is the world's largest oil importer (net); the former Soviet Union is the second largest exporter (net). The problems stemming from interdependency on petroleum are panoramic and touch almost all corners of the world. Some are more dependent than others, but all depend on oil or gas for subsistence (whether it be for consumption or domestic capital flow from exports). Economic growth within the industrialized and industrializing countries of the world is extremely reliant upon the oil and gas industry in order to bolster GDP and maintain a steady rate of industrialization.

The world consumes 65 million barrels of oil daily. Since geological and engineering information indicate with reasonable certainty that known reservoirs under existing economic and operating conditions are estimated at a trillion barrels of oil, there would apparently be just over 42 years of oil supplies left

in the world[17]. Will this in effect cause a crisis anytime within the near future? Most likely not, unless petroleum exports are interrupted by international conflict. Only then, will alternative fuels be of critical nature (as the case was in the mid 1970's). For now, the question of world stability (in a political sense) takes precedence due to the challenge for a new world order. Time will be of essence for economic stability once this quest for political stability has been attained. Now is the time for an economic policy within the international realm to be established along the line of a World Trade Organization which considers the stability of a world ten, twenty, or thirty years into the future.

Now consider the former Soviet Union, the world's second best prospective region for oil and gas development, as a haven for future petroleum prospects. After being shut out for several decades, Russia is gratified but also particularly reluctant (due to increasing nationalist tendencies) to draw Western companies technical expertise and capital into joint ventures to develop some of the largest newly available petroleum reserves available outside the Persian Gulf. Due to the immense differences between the Russian and OPEC oil, transnational petroleum companies prefer the exploitation of low-cost OPEC ("sweet") crude. On the other hand, the FSU provides a new frontier which contains many of the unknown reserves which entice those companies hoping to

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[17]J.E. Hartshorn, Oil Trade; Politics and Prospects (Cambridge, MA: Cambridge University Press, 1993), pp. 37-41.

make it big. Between OPEC and the FSU, no other oil provinces compare in terms of the volumes of known petroleum resources that can readily be brought towards production without further exploration.

There are two possible reasons why technical costs in ex-Soviet oil might turn out to be lower than in some of the other non-OPEC frontier areas where international companies operate. The first is that the former Soviet Union can offer known fields already appraised, without exploration risks. The second is that some of these are super-giants (over 1 billion barrels reserve), with fairly high well productivity. Most of these are remote even from Russian centers of consumption, often with high transport costs overland for internal consumption as well as to export terminals.

Apart from oil prospects, new ventures in the gas trade both within OPEC and the FSU may, by the turn of the century, offer participation on a scale not previously known. Gas is the favored energy source of the next few decades. It is moving in the direction to supplement and replace other fossil fuels in power generation (another reason for the significance of the FSU's 40 percent share of world reserves). As a highly convenient general fuel, it is becoming available in more regions, and able to meet what ever prices are charged for oil products. Gas seems certain to take over much of the market share that non-OPEC oil will eventually relinquish. Much of the additional gas consumption will move through international trade. Part of it will come from

OPEC countries, but not necessarily from all the main crude producers. At the very least, gas will diversify the sources of petroleum on which importing regions depend (another significant aspect of FSU natural gas)[18]. All of these additional reserves within the international market will add to the competition with OPEC oil.

B. FOREIGN PETROLEUM CONTRACTS

Since the demise of the Soviet Union, oil and gas contracts between the various FSU governments and many private transnational oil corporations have been materializing at rates not anticipated by Western analysts. These contracts are not limited to just the world's largest petroleum importers, but it includes Australia, Sweden, Denmark, France, England, Norway, Ireland, and various other OECD joint venture countries. The door has been opened, and any country with the capital and a high threshold for risky adventures is now a player. Russia, unlike many of the other former Soviet oil-producing republics, had divided its petroleum-rich regions into tracts in order to control the monopolist power of any single foreign oil company. In addition, the Russian Federation ensures 51 percent control of most fields in order to justify sovereignty of its petroleum industry. The rush to invest in the former Soviet Union (potential investment by foreign firms is estimate at $60-70 billion) has had some shortfalls due to an unfavorable climate of

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[18]Hartshorn, p. 277.

export restrictions[19]. For instance, the Russian Federation taxes on total revenue from petroleum sales instead of taxation of profits. For this reason, by the time foreign corporations pay taxes, the margin for profit nears zero. Without profit, initial investments cannot be paid off, and the return on investment plunges into the negative column. Thus, the reluctance to invest by smaller corporations is currently limited by unfair tax laws and export tariffs.

The contracts and joint ventures signed to date have included many well-known and established Western oil firms. These companies have established strongholds on some of the most lucrative undeveloped petroleum regions in the world outside the Middle East. The following contracts include some of the largest and most promising deals involving transnational oil companies: (1) Chevron Corporation (USA) has signed a contract with Kazakhstan in order to develop the Tengiz fields off the Caspian Sea (May 1992). This project is estimated to yield almost one million barrels per day by the year 2000 and estimated reserves between 30-60 billion barrels[20]. Problems that stem from Caspian Sea exploration include jurisdictional authority and distribution of revenue. The Caspian is surrounded by five countries (Kazakhstan, Turkmenistan, Iran, Azerbaidzhan, and the Russian Federation) which have refused to make concessions over the

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[19]"Russia aims for favorable climate for joint ventures", Oil and Gas Journal, August 10, 1992, p. 19.

[20]John Greenwald, "Black Gold Rush", Time Magazine, July 4, 1994, p. 54.

jurisdiction of petroleum rights within the Caspian Sea waters. This will be a major milestone if an agreement is to be reached; (2) Mega Oil USA/Vista Joint Venture, Inc., Oklahoma City, Oklahoma has signed a deal with Azerbaidzhan to work over 1500 wells and drill 400 more in the Baku region; (3) British Petroleum Co. and Norway's Den Norsky signed an agreement with the Azeri government to conduct a feasibility study of Chirag, estimated to hold one billion barrels of oil reserves; (4) British Petroleum and Unocal signed an agreement to develop Azeri field which is believed to hold 1.8 billion barrels of reserves; (5) Nationale Elf Aquitaine (France) signed a production-sharing contract with Moscow to develop various Volgograd-Saratov fields with estimated reserves considerable but undisclosed; (6) Amoco and Shell are developing sites in the Khanty-Mansiisk region of Western Siberia (this region along with the Siberian Tyumen region are the largest known reserves in the FSU and the most industrially developed); and (7) Royal Dutch and Shell have signed feasibility studies to determine the development of the Sakhalin Island (off East Siberian coast in the Pacific-Okhotsk Sea). The entire eastern coastal shelf of Siberia is estimated to contain 167.9-189.8 billion barrels of oil equivalent (BOE)[21]. This estimate (if correct) would place this region second to Saudi Arabia for total world reserves.

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[21]"Russia to offer huge eastern offshore Tracts", Oil and Gas Journal, May 10, 1993, p. 21.

There are various other pending contracts and joint ventures but many have not been approved by the respective governments. If more Western countries are allowed to exploit the massive unaccounted reserves within the FSU, these new contracts could be the first in a slew of petroleum deals in the FSU that could reshape the world oil industry in the next century. Many geological analysts estimate up to 250 billion barrels of oil equivalent (BOE) will be discovered in Russia, Kazakhstan, and Azerbaidzhan. This is one fourth of the actual world reserves at present (1 trillion BOE)[22]. The potential for new reserves is massive, but without international assistance, production possibilities will most likely never be achieved (and will not reach 1988 production levels).

The process of acquiring contracts, licenses, and registrations for petroleum exploitation is a constantly changing business within Russia. Many times the inherent flaws within the legal system which prevent foreign investment (e.g., high taxes and changes enacted through presidential decrees) are also the very ones created through bureaucratic controls on private Russian enterprises. For Russia and the independent states, the legal systems provide the true reform which would establish the necessary framework for impartiality and permit a more profit oriented atmosphere.

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[22]Rose Brady and Peter Galuszka, "The Scramble for Oil's Last Frontier", Business Week, January 11, 1993, p. 42.

There are numerous other considerations which must be pondered by a transnational oil corporation prior to entering any contract. These include tax treaties, loans, arbitration, and political risk insurance. The tax treaty currently in effect between Russia and the U.S. allows for a current withholding rate for repatriation of all profits outside Russia at 15 percent. The tax treaty is negotiable but has not changed since the USSR-U.S. Tax Treaty was enacted in 1973. Today, a new treaty with the following provisions is expected to be ratified by both states: (1) withholding tax on dividends will be reduced from 15 percent to 5 percent if western ownership of the stock is greater than 10 percent; (2) Russian withholding tax of 15 percent on interest income will be eliminated; (3) Russian withholding tax of 20 percent on royalties will be eliminated; and (4) Russian profits tax is anticipated to be creditable for U.S. foreign tax credit purposes. These provisions of the treaty may make it more advantageous for western companies to directly invest in Russia rather than through offshore companies in countries such as Cyprus.

Loans can also be another major barrier to companies with limited assets. The capital investment for an initial venture is typically the responsibility of the western company. The western company provides the capital for the venture in the form of a loan to the venture. The loan is repaid in a priority position from the venture revenues. The loan is collateralized with the venture assets or is guaranteed by the Russian partner (if there

is one), with oil reserves or tangible venture equipment. The loan is repaid to the western company with the capital portion not subject to repatriation tax. By capitalizing the venture in the form of loans, the venture profitability is delayed which defers the application of profits tax. The payout of the venture occurs after the loan is paid. For these reasons, we see many loans which extend 30-40 years into the future. In addition, western companies must also be apprised of current treaties and laws which are many times circumvented by presidential decrees which take a higher precedence.

With this in mind, the willingness to go to arbitration can be a very significant agreement between parties prior to signing any contract. Russia signed the United Nations International Convention for the Settlement of Disputes (ICSOD) on June 16, 1992. This provides options for the resolution of investment disputes pursuant to ICSOD procedures with the ICSOD Secretary General acting as the appointing authority of arbitrators. ICSOD is beneficial for western companies because there is a set procedure for arbitration including resolution of any issues concerning jurisdiction as well as a mechanism for collecting on judgements. Agreements must refer to the treaty and consent to ICSOD jurisdiction to be effective.

Lastly, every investment carries some form of risk including technological, foreign exchange, marketing, cultural, and political. The term "political risk" has become a catch-all phrase to include any risk attributable to politically related

sources. Political risk insurance is an option many investors are considering. The U.S. provides coverage through the Overseas Private Investment Corporation (OPIC). OPIC, a federally chartered insurance program that provides coverage for new investments if the investment is approved by the Russian government, benefits the socio-economic development of Russia and does not conflict with U.S. national interest.

OPIC programs provide insurance against loss due to specific risks including war, revolution, insurrection, expropriation, abrogation of contractual rights, and incovertiblity of currency. Risk insurance is by no means a panacea (along with ICSOD). When an operation is expropriated, the investor is only compensated for the value of the assets without taking into account future cash flow value[23]. This insurance is primarily a tool to encourage private enterprises to enter the world of transnational resource exploitation. Risk assessment must ultimately be weighed against the profitability of the known resources. In the end, the profits taken home are the only real measurement of success.

C. PIPELINE ISSUES

The infrastructure for oil and gas pipelines within the former Soviet Union is as much a problem as is the lack of production and exploration. The need to repair, upgrade, and extend existing pipelines would considerably expand production

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[23]Jack and Karen Krug, "Russian Ventures". Oil and Gas Journal, February 22, 1995, pp. 66-69.

capability. Most of the existing pipeline and exploration equipment technology is over thirty-five years old. Consequently, the past two years has produced numerous pipeline accidents and the spillage of thousands of barrels of crude into the surface environment. Spills and pipeline breaks are mainly caused by metal fatigue which ultimately results in the loss of production. The lack of funds has caused the problems to escalate without any foreseeable relief. The necessity to entice western technology and capital is now a priority and not just a future interest.

The transport of more than 90 percent of oil production is accomplished through a massive pipeline network which is operated by Transneft (the former national oil transport ministry). The total length of this system is about 43,470 miles with 600 pumping stations and a storage capacity of over 107 million barrels. The scale of this system and its significance to both the domestic and export economies places Transneft in a critical position as facilitator of intrastate trade, hard currency generation, and ultimately economic stability. Transneft's pipeline operations is controlled by 17 regional centers, 10 of which are within the Russian Federation[24]. The efficient operation of these centers is crucial to the move towards a market economy.

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[24]Paul Davies, "The Challenge of New Pipeline Systems in Russia and the Republics", Pipeline and Gas Journal, March 1992, pp. 22-25.

Transneft controls the flow of oil throughout the independent states. This government agency works under Rosneftegaz which is the sole coordinator for all oil and gas deliveries. Rosneftegaz works directly for the Russian Federation government. This system which is similar to the former Soviet system of Ministry for Oil and Gas will most likely not change anytime in the near future. Currently, it is necessary to have one agency coordinate the overall operations of the pipeline system which is predominantly contained within the Russian Federation's petroleum network. This system of control directly benefits Russia as the sole provider and transport link to foreign and intrastate markets. This is very similar to the command economy under the Soviet Union. The pattern of gas pipeline construction and control has essentially followed that of the oil pipeline network. The unified gas supply system which consists of gas reserves, transmission systems, is under the control of Gazprom (the largest natural gas supplier in the world). The former Soviet gas pipeline network totals 43,500 miles of transmission pipeline. The major construction emphasis has been in Western Siberia in order to bring gas westward for domestic consumption and export. Like the oil pipelines, Russia controls over 85 percent of the entire network[25]. Due to the enormous control of the pipeline networks by the Russian Federation, all the independent states depend upon Moscow either

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[25]Davies, p. 28.

for petroleum supply, transmission, distribution, or internal security.

In some instances, the degree of dependency is also a factor for Moscow. Due to the division and concentration of certain industries in specific regions during the Soviet era, some industries such as the manufacturers of petroleum industry equipment and supplies are concentrated in one region, Azerbaidzhan. Russia receives over 60 percent of its oil field equipment from Azerbaidzhan. This equipment is not very good but until a better source is found from Western technology and the funds are available for purchases, Russia will sustain current production with antiquated technology. Russia still has the upperhand since the majority of Azeri petroleum must be transported through the Northern Caucasus via Grozny and on to Western markets. Baku authorities are attempting to modify this situation by finding alternative routes to transport petroleum. Currently, there exists four alternative routes, but each poses serious problems.

The first option is to pipe oil out through Iran to the Persian Gulf. For a moderate fee, Teheran could make their pipeline available for crude oil from the Azeri field. The Western interest through a consortium of Amoco, Britain's British Petroleum, and Norway's Statoil have joined together to take a share in the Azeri venture, but the ideological differences in the political atmospheres in Iran and the U.S. has prevented the

signing of a contract with Tehran[26]. This route will most likely not be an option for any time in the near future.

The second option is for Azerbaidzhan to utilize an existing oil pipeline to the Black Sea via Armenia and Georgia. This pipeline has been shut down due to the pogroms and internal conflict in the Nagorno-Karabakh region and the unrelated civil unrest in neighboring Georgia. There also exists technical pipeline problems stemming from pumping station maintenance and sabotage. Until the ethnic rivalries cease, the Azeri government and the Western consortium will not risk sending oil across this route[27].

The third option is to build a pipeline across Turkey to an outlet on the Aegean Sea. Turkey seeks to build a pipeline from Turkmenistan through the Caspian, or Iran, Azerbaidzhan, and then to Eastern Turkey. With this in mind, Turkey could have predominance over the region's economy and the surrounding states would become satellites of whoever controlled the pipelines and ports. Russia, however, would never tolerate such a situation since the Black Sea trade is vital to the Russian Federation's export trade and access to the Straits into the Aegaen Sea. In addition to the complexities of this situation, the U.S. supports Turkish claims regarding the dangers of oil spills by Russian

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[26]Peter Fuhrman, "Caught between the Republics", Forbes, October 14, 1991, pp. 44-45.

[27]Stephen Blank, Energy and Security in Transcaucasia, (Carlisle Barracks, PA: Strategic Studies Institute Army War College), September 7, 1994, p. 10.

tankers in the Black Sea. Major oil spills have occurred due to tanker collisions which pose a serious ecological threat to Turkish shorelines. A further complication has been the attack of Kurds who have already caused major damages to Turkey's existing pipelines[28]. These threats, if not resolved through peaceful means, will soon make the entire project extremely doubtful.

The fourth alternative would be the utilization of Russian pipelines, but this creates a myriad of problems which the Azeris are not willing to resolve. Russia has threatened to not mediate and provide peacemakers for the Karabakh War if Baku does not provide Moscow with twenty percent of all oil revenues[29]. This would, in fact, allow the Armenians to further dominate Azerbaidzhan. Moscow could become more politically effective if Azerbaidzhan were isolated politically and militarily from other states, since Turkey and Iran will not intervene unilaterally or jointly against Russia[30]. Azerbaidzhan has resisted all Russian peace plans because they remove Azeri land and resources from Baku's control and sovereignty and place Russian bases on Azeri

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[28]Stephen Blank, Turkey's Strategic Engagement in the Former USSR and U.S. Interests (Carlisle Barracks, PA: U.S. Army War College), July 1994, pp. 55-88.

[29]Levine, "The Bear Pauses", The Economist, December 11, 1993, p. 62.

[30]Stephen Blank, Turkey's Strategic Engagement in the Former USSR and U.S. Interests (Carlisle Barracks, PA: U.S. Army War College), July 1994, p. 58.

land[31]. All this indicates that while Russia is not responsible for the war, it is exploiting the conflict to promote clearly inequitable objectives.

Other regions within the Russian Federation are also having their share of problems with petroleum pipelines, but the competition between states, petroleum companies, and political persuasions is not as prevalent. For instance, the Trans-Urals Pipeline, which will extend from South Balyk in Western Siberia to the Volga-Urals region, will replace the non-gas liquid (NGL) transportation system that has been inoperative since the disastrous explosion near Ufa in 1989. This new pipeline will provide the needed boost to the ailing energy and petrochemical industries and will greatly reduce wastage of the abundant associated liquids. In order for Moscow to control project economies along the pipeline route, an annual hard currency royalty to local authorities along the pipeline right-of-way is paid proportional to the total length of the pipeline in their jurisdiction.

The drive for growth in the former Soviet oil and gas industry and the increased autonomy of the independent states provides great potential for Western companies to participate in the domestic pipeline industry. Some of the specific factors include: (1) the need to increase production to satisfy domestic demands and increase exports to support economic revival; (2) the need to overhaul and repair the unreliable and deteriorated

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[31]FBIS-USR, October 29, 1993, p. 50.

existing oil and gas pipeline systems; and (3) the need to develop an increasing number of smaller, more remote fields to maintain production levels, leading to an increase in average transported distance and overall pipeline length. Hydrocarbon transportation will form an intrinsic part of the major investment expected in the petroleum industry[32]. The key areas for Western involvement are capital construction of new systems, maintenance and repair of pipelines and compressor stations, and the application of sophisticated inspection techniques for ensuring continued safe operation. Only outside assistance from Western technology will permit the petroleum industry of each respective oil and gas local economy to survive and flourish into the twenty-first century.

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[32]Paul Davies, "The Challenge of New Pipeline Systems in Russia and The Republics", Pipeline and Gas Journal, March 1992, p. 29.

III. RUSSIAN PETROLEUM AS AN ECONOMIC - CONFIDENCE BUILDER

In the twentieth century, Russia has consumed an inordinate amount of energy in order to support an economically backward society and an extraordinarily wasteful military-industrial complex. The current situation in Russia suggests efficiency and environmentally-safe fuel regulation will not be a priority anytime in the near future due to the lack of effective petroleum reform by the Yeltsin administration.

This chapter will analyze ineffective Russian oil and gas policy which has stagnated domestic production and impeded international exportation. The geopolitical situation in the former Soviet Union is in a state of turmoil. Azerbaidzhan, Turkmenistan, and Kazahkstan, which currently produce oil and have formalized contracts with transnational oil corporations are experiencing setbacks due to internal war, the deterioration and lack of oil pipeline infrastructure, and Russian claims to a percentage of energy revenues[33]. Energy is exclusively the prime economic commodity which can benefit the oil-producing states, but unfortunately, they are currently unable to break the bonds of Moscow.

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[33]e.g., Russia claims 10-20 percent of all revenues from petroleum sales in Azerbaidzhan in exchange for unilateral security guarantees by the Russian Armed Forces. The deterioration of the petroleum infrastructure is due to the lack of maintenance and water incursion.

A. CURRENT RUSSIAN PETROLEUM POLICY

The Soviet Union's oil industry throughout the communist era has been characterized by numerous reorganizational activities. For example in 1957, Khrushchev abolished central control of the oil industry and created 110 regional sovnarkhozs (independent control centers). The idea was to transfer sufficient limited power from Moscow to the regional republics. This may appear at the surface as an ideal position for establishing further republican autonomy, but in reality, the central functions of control were held on to by GOSPLAN (the State Planning Organization). Throughout Khrushchev's reign of power and including his successors, the energy policy and administrative functions changed periodically.

The greatest problem of oil during the communist era was the fluctuations of total yield. By the end of the 1930's, yield from the Baku fields diminished dramatically due to overproduction. Production fell temporarily in 1932, and impressively increased again until 1938, then leveled off[34]. The targets set for the end of the second Five-Year Plan (1938) lagged behind the estimated petroleum production quotas. The limited technology at the disposal of the Soviets could not increase the production at the historical fields in Baku and Grozny. Fortunately, significant new fields were discovered between the Volga and the Urals. This region, referred to as the

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[34]Marshall I. Goldman, The Enigma of Soviet Petroleum (London: George Allen & Unwin Publishers, 1980), p. 30.

'Second Baku', did not begin to produce petroleum until after World War II due to a shortage of proper drilling equipment[35].

Why is this background significant to the Soviet petroleum industry, now under Russian auspices? The oil industry has consistently gone through states of change. The petroleum policies prior to the Bolshevik Revolution and World War II display similar characteristics of those experienced today. For example, the Soviets sought technological assistance and foreign marketing of their petroleum. Companies like Standard Oil and Shell exploited the chance to sell and market Soviet oil. The concept of permitting multinational enterprises to conduct trade did not pose an ideological threat to the Soviets. The Soviet Union (politics aside) did not hesitate to sell oil to Hitler's Nazi Germany or to Mussolini's fascists, even when the popular political line should have precluded such action[36]. In the USSR, ideology very rarely stood as a barrier to the principle of profit.

Due to the possibility of future energy shortages, the Soviets justified the need for foreign assistance. The fear of losing production (necessary to supply domestic demand and provide foreign currency) was in the forefront of oil and gas policy. A percentage of oil prior to World War II (about 29 percent) was set aside for strictly export markets. This policy

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[35]Iain F. Elliot, The Soviet Energy Balance (New York: Praeger, 1993), p. 72.

[36]Marshall I.Goldman, The Enigma of Soviet Petroleum (London: George Allen & Unwin Publishers, 1980), p. 30.

continued up through the 1970's, but eventually by the mid 1980s levels climbed above 50 percent of export revenues; and today, the Russian government receives 60 percent of export revenues through oil exports[37]. These figures suggest the dependency of Russian markets upon the foreign exchange from oil revenues.

Just over seven years ago, the Soviet Union was the largest oil producer with an annual production capacity of over 12.5 million barrels of oil per day. The Soviet Union could afford to postpone economic reform at that time. Today with annual production at less than 7 million barrels per day, the revenues do not even account for the increase in inflation. Due to the poor economic performance and decrease in domestic demand for oil, the impact of Russian oil upon the world market has been negligible. Hard currency from exported products (especially petroleum) is essential for any type of economic recovery. At current hyperinflated rates, oil and gas earnings are only half Moscow's entire budget deficit[38].

Even though oil production continues to decrease, the estimated number of reserves continues to grow. Reserves estimated in the last couple of years have quadrupled since the 1980 estimates[39]. One must remember that less than seven years

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[37]Howard Banks, "The Land of a Thousand Leaks", Forbes, July 8, 1991, p. 35.

[38]Daniel Yergin and Jospeh Stanislaw, "Oil: Reopening the Door", Foreign Affairs, September/October 1993, pp. 85-86.

[39]Daniel Yergin and Thane Gustafson, Russia 2010 - And What It Means for the World (New York: Random House, 1993)p. 115.

ago the Russian oil industry was still closed to the outside world. Estimates were not based on geological surveys. Today, transnational oil companies and foreign investors are more aware of the potential hidden fortune within the former Soviet borders. The problems stem from open but restrictive Russian petroleum policies. These policies rely upon controlling the flow of oil to the independent states[40], controlling the flow of oil out of the independent oil-producing states, placing taxes (as high as 70% of gross revenues) on oil exported by Western transnational oil corporations, and annulling terms of foreign contracts without prior notification.

Russia does not possess any written policy which specifically plans or imposes directives on formal oil and gas policy. Boris Yeltsin compounds decree upon decree in order to establish political legitimacy for his presidency. This is evident from the following events: the Russian Army was able to manipulate a decree from President Yeltsin which allowed it to keep more money made from arms exports, another event is the various decrees declared by Yeltsin which have cancelled tax treaties and increased royalties paid to the state. The unequal division of state powers within the Russian Federation creates a massive advantage to the power of the president(this dates back to the coup of 1993). This behavior creates an atmosphere of

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[40]These independent states refer to the former Soviet republics which receive a majority of their petroleum from Russia. The independent oil-producing states include: Azerbaidzhan, Kazakhstan, Turkmenistan, Ukraine, and Russia.

illusion and corruption. Could this be construed as a capitalist venture, or does such action insinuate a lack of concern for the economic security of Russia or just a weak submission to political pressure? The loss of a political ideology and the adherence to a weak constitution has created corruption within Russia that can only be changed through distinct division of power between president and parliament, empowerment of the public through impartial ballot box elections, and the encouragement of public freedom of expression and capitalist enterprise in the private sector. When a leader such as Yeltsin, has been admonished by past economic and political adversity, pragmatic resolutions should guide him towards continued reform. This is not the case within the borders of the Russian Federation.

The oil and gas industry has more ancient built-in giveaways than any other industry. Transport costs are extremely high (due to lack of maintenance and transport losses from pipeline leakage) while the cost for a single barrel of crude oil ($6.50 within Russia) is conversely low in order to offset transport costs. Taxes and export levies have been eliminated for domestic oil companies, but conversely, foreign companies must pay an exorbitant penalty for cooperating with Russian demands for new oil well exploitation and development. The paradox of such policy has been new taxes on Western companies of about $100 million and concessions to Russian oil exporters at a cost to the Russian Treasury of almost ten-fold. The United States in 1993 saw the urgency to capitalize and assist in the

development of Russian oil by earmarking $2 billion dollars for credits and guarantees to U.S. oil companies willing to invest in Russia's oil industry. None of this money has been claimed since some U.S. companies do not trust President Yeltsin and cannot foresee taking such a high risk (this excludes some of the larger companies like Chevron and Amoco who believe the risk of not investing in Russian oil could be even more costly)[41].

Corruption appears to be the primary source of inconsistent petroleum policy. A former minister of economics under President Yeltsin claims that the recent revocation of special export licenses to certain Russian firms has created mass confusion. According to this source, export licenses are the major source of graft; to obtain one, Russian companies fork over to bureaucrats a bribe equal to 10 percent of the expected annual revenues from the license.

Many of the ideas for petroleum policy are promulgated by former Communist Party technocrat and boss of Gazprom, Prime Minister Chernomyrdin. Yeltsin and Prime Minister Chernomyrdin have bestowed special privileges on companies such as Gazprom which include exemption from import duties and taxes, and deals which allow it to convert the dollars earned on gas to rubles at double the official rate[42]. Such policy has intimidated transnational oil corporations from building capital investment.

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[41]Peter Fuhrman, "What Boris Gives . . .", Forbes, August 15, 1994, pp. 42-43.

[42]"Steady Rise in Oil, Gas Demand Ahead", Oil and Gas Journal, June 6, 1994, p. 34.

An objective investor would have yelled foul much sooner, but the enormous prospects for billions of barrels of unclaimed crude oil and comparable gas reserves are too valuable to leave untouched. One has to wonder whether Yeltsin's actions merit approval from the old party line or his corrupt behavior is just a phase in the establishment of a market economy. Boris Fyodorov, the former finance minister, suggests that its a "replay of the last days of Gorbachev, with the leader talking about reform while granting favors and privileges to the groups who most strongly oppose it"[43].

Russian petroleum policy with respect to the independent states has demonstrated even more deterioration. Moscow has used the control of oil (e.g., restrictions placed on the disposition of oil and the rationing of fuel) to force or at least persuade the states of Ukraine, and Belarus into an economic integration and political unity with Russia[44]. Mikhail Gorbachev attempted to force the subjugation of the Baltics by cutting off their energy supply, but the Baltics made requests from Western suppliers and were spared an economic debacle. This policy of economic warfare is not an isolated incident. In March 1994, Russia slashed deliveries to Ukraine and Belarus due to combined unpaid debts of over $1.14 billion to Moscow. Due to the drastic cuts, Ukraine has reportedly siphoned off oil supplies destined

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[43]Quoted from Peter Fuhrman, What Boris Gives . . .", Forbes, August 15, 1994, p. 43.

[44]Jerry F. Hough, "Russia Aims its Oil Weapon", The New York Times, June 17, 1993, p. A25.

for Turkey from pipelines transversing its territory[45]. The obvious ramifications of this untimely action has created a situation of dependency on Russia for economic survival.

The imperialistic policy observed here places the motives by Moscow at risk with the reform necessary to build a functional economic community. The states which produce oil for interstate markets, primarily Russia, Azerbaidzhan, Kazakhstan, and Turkmenistan are dependent upon petroleum exports for their primary path to the world market. The necessity for future investment and development depends primarily upon the hard currency revenues available through the export of oil and gas. Control over petroleum is the only foreseeable means of securing a future manifested with the choice of economic and political freedom.

Petroleum policy within Russia and the independent states is at a critical juncture. The need by the independent states to acquire enough oil for daily operation is the first milestone. Next, policy must put forth limited restrictions on foreign companies in order to attract Western development. Moscow must also be willing to harmonize political and economic relations with the independent states before internal war consumes the entire former Soviet sphere. The imperialistic tendencies, noted by Western experts, must be abated through the realization of common grounds and the formation of a unified ideology

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[45]"Russia Slashes Energy Deliveries", The Oil and Gas Journal, March 4, 1994, p. 4(1).

(preferably political independence and economic unity). The process of building free markets will only be possible through less restrictive controls. Petroleum policy cannot become standardized unless cooperation is sought by all.

B. INTERSTATE RELATIONS

The relationships between Russia, the Transcaucasian states, the Central Asian states, the Baltics, Ukraine, Belarus and Moldova are complex and constantly changing due to a lack of foreign policy concensus. Oil is the primary foundation of many of the disputes which directly affect the economic survival of most of the states of the former Soviet Union. Less than half of the FSU states produce their own petroleum products, but they all depend upon one another for crucial petroleum trade. The focus here will be the dependent nature of trade relationships and the specific action and reaction of Moscow's behavior towards the independent states. The most crucial and probably the most threatening region for instability is the Transcaucasus. Besides the existence of warring factions, the flow of oil has been disrupted through piracy syphoning while in transit through this volatile region. The major motivation for terminating the persistent corruption between states is the rewards for economic cooperation. As detailed by many of the experts in the post-Soviet field of studies, the problems dealing with the lack of cooperation originate mainly from ethnic diversity. This study will not focus on the solvency of ethnic disputes but rather the action by Russia (Moscow) to provoke ethnic conflict and then

offer solutions (usually by military intervention disguised as peacekeepers) to thwart international influence and to gain the upper hand in Transcaucasian internal matters. Steven Blank, the professor for post-Soviet studies at the U.S. Army War College captures this idea very well:

> *Russia is obviously motivated by the lucrative possibilities implicit in being a key player in all aspects of the energy business, e.g., by directing the energy trade flows of the other post-Soviet republics in Transcaucasia and Central Asia back to it and its transport network*[46].

Russia does not explicitly use doctrine or mutual agreements to interject solutions for this region but rather an implicit use of imperial legacy. Since the demise of the Soviet Union, independence of these states has not automatically granted freedom of mineral rights. This is proven through the linkage of Russian military intervention and Moscow's claim to unrelinquished energy rights.

Azerbaidzhan, the main producer of oil and gas in Transcaucasia, is hampered by an intense struggle with Armenia over the former province of Nagorno-Karabakh. The effects on both states have been extremely costly. This former province has sought its autonomy from Azerbaidzhan dating back to 1988. The population of Nagorho-Karabakh consists mainly of ethnic Armenians. The ensuing struggle has virtually brought both economies to a standstill. Consequently, the Russian government

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[46]Quoted from Stephen J. Blank, "Energy and Security in Transcaucasia", Strategic Studies Institute, U.S. Army War College, September 7, 1994, p. 1.

under Boris Yeltsin has exploited the situation by imposing a peace settlement to enhance Moscow's regional strategic position. If Moscow can impose a peace plan of its own, the result could be a possible payback of oil and gas. One can only speculate about the ulterior motives, but one thing is certain Russia does not have explicit motives.

To complicate matters, the struggle for oil in this region involves additional players to include Turkey and Iran. In March 1992, Turkey proposed a solution to the Karabakh War which would bestow upon it unmediated access to a direct pipeline from Turkmenistan that bypassed regional Iranian and Russian influence[47]. Moscow was extremely upset that such a scheme was even considered by Turkey since it had no economic grounds to base its claim. With such a pipeline, Turkey, Azerbaidzhan, and Central Asia could be integrated into a single economic community in the absence of Russian influence. Turkey would be the collection and tranfer point to Western markets via the Bosporus and Dardanelles.

Iran, on the other hand, has a special relationship with Moscow which permits it access to this region but under Russian auspices. Teheran also has very good relations with Armenia and Azerbaidzhan but only because these states fear a Russian/Iranian coalition of force from both the north and the south. The relationship between Moscow and Teheran rests on the latter being

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[47]Paul A. Goble, "Coping with the Nagorno-Karabakh Crisis", Fletcher Forum of World Affairs, Summer 1992, pp. 19-26.

a prime recipient of the Russian arms trade still in effect since the days of the Soviet Union. Russia places restrictions (e.g., influence through limited trade, and power politics due to arms trade) on Teheran mainly due to its Muslim fundamentalist threat. This appears to be the biggest threat from the south.

The Nagorno-Karabakh conflict has many sides (CSCE, Russia, Turkey) to the proposed mediation process. The CSCE Minsk Group attempted several sessions of negotiations to terminate hostilities, but each was rejected by Azerbaidzhan since no provisions were made for an Armenian withdrawal from the Lachin Corridor and the return of refugees displaced by the fighting were not considered in the resolution[48]. In 1993, Yeltsin's envoy Kazimirov stated that Russia would resolve the conflict on one of four levels: as a member of the CSCE Minsk Group, with the United Nations, acting independently, or on the basis of bilateral consultations. Russia worked for a unilateral Azeri resolution which would place Russian troops within Azerbaidzhan with a stipulation that Russia would be guaranteed a share in the Western Consortium that is to develop Azeri offshore oil deposits. Moscow can afford to focus on an Azeri solution since the economic benefits directly relate to Russian economic advantages. Georgia and Armenia already depend upon Russia for most petroleum products. For this reason, Russia can focus its efforts on Azerbaidzhan and the prospective oil deposits.

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[48]Elizabeth Fuller, "Russia, Turkey, Iran, and the Karabakh Mediation Process", RFE/RL Research Report, Volume 3, Number 8, February 25, 1994, p. 32.

The instinctive reaction from Azerbaidzhan was to reject any coercive resolution from Moscow in order to secure a future of economic and political independence. Ironically since the defeat of President Abulfaz Elchibey (by a coup) and the ruling Azerbaidzhani Popular Front in June 1993, the former Azerbaidzhani Communist Party First Secretary Geidar Aliev, has considered fundamental changes to foreign policy with regard to an impending defeat in the Nagorno-Karabakh conflict[49]. The modification to this policy (which originally refused formal relations with Moscow) involved a rapprochement with Russia and membership in the Commonwealth of Independent States. This policy position compromised any advancement made since the establishment of independence by allowing Moscow a voice in the resolution of the conflict. Such recourse promotes an ideal position for Russian influence to capture a foothold in the region. Due to the poor performance by Azerbaidzhan in the Nagorno-Karbakh conflict and the change of political administrations, Russia now has the means to exploit local instability for its own geopolitical benefit[50].

The Western (primarily the United States) and Turkish 1992 pipeline plan mentioned earlier was drawn up by Paul Goble, a U.S. State Department expert on nationalities. According to Moscow, this plan allowed Washington to covertly support Turkey's

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[49]Fuller, p. 51.

[50]Stephen J. Blank, "Energy and Security in Transcaucasia", Strategic Studies Institute, U.S. Army War College, September 7, 1994, p. 7.

proposals and coincidently redraw the balance of power in the Caucasus and Central Asia[51]. This scenario explains the failure of the CSCE Minsk Group proposed solution of placing and controlling peacekeepers in the region. Moscow would not allow Western involvement in a problem involving only former Soviet republics. It can be postulated from this situation that a Western solution to the turmoil in the region will not be seen any time in the near future. As for the production and distribution of Azeri oil, the future seems bleak until all parties can agree on their role as part of the solution. The current conditions suggest a stalemate with all parties losing economic benefits and gaining only greater political and economic turmoil. The Russian objective appears to be a coercive attempt to draw the Transcaucasian states back into a "Russian-dominated states system with a lasting Russian military presence to be paid for by Azeri oil shipments to Moscow and Russian participation in the regional energy economy with no prior investment"[52].

Azerbaidzhan is by no means the only state in the Caucasus which depends on the petroleum trade in the region. The states of Armenia and Georgia do not produce their own oil but depend almost exclusively on oil from pipelines which transverse through Ukraine and Russia. Much of the oil flowing into this region

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[51]Stephen Blank and Colonel William Doll, The Gendarme of Eurasia: Peacemeaking a la Russe Carlisle Barracks, PA: Strategic Studies Institute, U.S. Army War College, 1994, p. 8.

[52]Stephen J. Blank, "Energy and Security in Transcaucasia", Strategic Studies Institute, U.S. Army War College, September 7, 1994, p. 9.

must cross through the Russian autonomous region of Chechnya where currently Russian and Chechen troops are fighting over Chechnya's independence. The involvement of these regions with internal and external war has created a state of economic uncertainty. The Armenians and Georgians do not know how much petroleum will be delivered and when it will be delivered. In addition, both states have enormous debts for petroleum already delivered.

Georgia has been fighting its own internal war with the Abkhazians and also the Southern Ossetians. Russia has attempted to mediate the process and convince all sides the fighting would be futile, but particularly the Georgians have spurned such resolution. Moscow neglects to see the significance of Georgian export market in bolstering economic confidence (besides an outlet for cheap oil and gas) for Russia, so the main resolution has been threats to stop the fighting or face economic sanctions. For example in June of 1993, Foreign Minister Andrei Kozyrev visited Tbilisi and gave the following warning: "Russia can no longer allow people to die, cities to be destroyed . . .; we believe it is inadmissible to violate a ceasefire"; he continued by threatening economic sanctions, specifically terminating oil supplies, against which ever side renewed hostilities[53]. This statement by Kozyrev appears almost hypocritical compared to Russia's current atrocities in the Chechen conflict in Grozny.

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[53]Quoted from Elizabeth Fuller, "Russia's Diplomatic Offensive in the Transcaucasus", RFE/RL Research Report, Volume 2, Number 39, October 1, 1993, p. 31.

Double standards had never been a weak point for Moscow throughout the Soviet era.

In September of 1993, Russian Defense Minister Grachev proposed to deploy two Russian divisions to Abkhazia as peacekeeping forces, but this was rejected by the Russian parliament to the dismay of Eduard Shevardnadze (Georgian State Council Chairman). A few days later Defense Minister Grachev stated that he believed neither side wanted peace and a settlement was not up to Moscow but the United Nations[54]. It is evident from this statement that Moscow was ready to defer the resolution to the international community since no economic or political benefit was in the cards for Russia. This is the antithesis of the aforementioned Russian approach to the Nagorno-Karabakh conflict.

States such as Ukraine, Belarus, and Moldova, rely heavily on cheap imported oil from Russia. Of the three, Ukraine is the only one which can produce approximately 11 percent of its domestic consumption (equal to about 19 million barrels per year). The other two states produce less than five percent of the domestically consumed petroleum. Ukrainian state-owned oil firm, Ukrnaft, has signed a contract with a Canadian-owned oil firm, UK-ran Oil, to began enhanced recovery techniques on the known oil wells in Ukraine. This operation along with new exploration in the Carpathian region and the Black Sea shelf is estimated to give Ukraine complete energy self-sufficiency within

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[54]Krasnaya Zvezda, September 21, 1993, p. A-1.

ten years[55]. As for the states of Belarus and Moldova, there appears to be no way of breaking the economic bonds with Moscow, since they cannot afford to pay market prices for petroleum. Belarus comes the closest but less than ten percent of petroleum can be produced locally. They have the capability of refining more than 1.5 times the daily consumption ratio, but refining capacity is useless without the crude oil production[56]. Both states understand that a close relationship with Moscow is indispensable and unavoidable.

The Baltic states of Estonia, Latvia, and Lithuania as observed from their split from the Soviet Union have shown no resolve for gaining closer ties with Moscow. Yeltsin has stated to the Baltics and Ukraine (with reference to their independence and break with Moscow) that they must "immediately" pay for Russian energy with hard currency at world market prices. This is extremely difficult when hard currency is not readily available for expensive oil imports. The practice of modifying trade relations by playing "the energy card" to influence political election outcomes and to capitulate economic freedom has been a common practice since the demise of the Soviet Union[57]. In the Baltics, the "energy card" has been utilized

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[55]Marco Levytsky, "First Canada-Ukraine Oil Deal to be Signed Soon", Ukrainian News, October 1994, p. 3.

[56]"CIS Members Seeking More Russian Crude", The Oil and Gas Journal, Volume 91, Number 29, p. 19.

[57]Elizabeth Fuller, "The Baltic Question", RFE/RL Research Report, Volume 2, Number 17, April 12, 1993, pp. 44-47.

mainly for protecting the interests of the Russian-speaking minorities. The Baltics do not depend upon Russia for energy (although they are open to negotiation). The West has been extremely generous in extending credits and loan guarantees for energy products. The Baltics appear to be the most independent and resourceful of all the independent states when dealing with the power-politics of Moscow. They will survive without regard to any carrot or stick antics imposed by the Yeltsin administration.

The Central Asian states of Kazakhstan, Uzbekistan, Tajikistan, Kyrgyzstan, and Turkmenistan have their own petroleum problems. The basin of the Caspian Sea offers astronomical oil prospects for Central Asia as well as the Caucasus. The most significant Central Asian field is located in the Tengiz Basin of Western Kazakhstan. The government of Kazakhstan has already signed a reported $20 billion deal with Chevron Corporation. Reserves are estimated at over sixteen billion barrels, about one-sixth the proven reserves of Kuwait. The unidentified reserves range from ten billion to over one hundred billion barrels. Another twelve billion barrels of oil lies under the Caspian Sea which is controlled in fields by Russia, Azerbaidzhan, Turkmenistan, and Kazakhstan[58]. A field in North Ustient shared by Kazakhstan and Uzbekistan has been identified with over one billion barrels of crude. The problems with

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[58]Michael Mandelbaum, Central Asia and the World (New York: Council on Foreign Relations, 1994), p. 139.

exploiting these fields have been the absence of transnational pipelines to transport the oil to market and the extremely high sulfur content which requires a complex and expensive refining process in all the fields.

The Western interest in oil in this region is compounded by the lack of a formal petroleum policy which has never been enacted by these states. The West seeks to add Central Asian oil exports to the world's supply, sell technology and expertise necessary to exploit the Central Asian fields, and limit any participation by the state of Iran. The "Iran factor" which poses a major threat to the region (e.g., pipeline control and the infiltration of Islamic fundamentalism) can only be minimized through Western monetary assistance subject to strict limitations (e.g., prohibit contracts with Iran in return for financial assistance which was a position taken by the former Bush administration).

The Central Asian problem of ineffective and nonexistent petroleum policies directly relates to the unanticipated and expeditious fall of the Soviet Union. Since independence came so quickly, the Central Asian leaders had virtually no time to formulate petroleum policies with their suppliers. In reality, this region was a pawn for whichever state had the desire and connections to exploit the weaknesses of each Central Asian state. The initial states which delved into this region in competition with each other for influence and leverage were Turkey, Iran, Pakistan, and Russia. These states were able to

convince Central Asia that they had much in common (e.g., religion, culture); and that it would be a mistake not to unite their peoples under a blanket of shared heritage.

Turkey became the catalyst for future relations among the Central Asian states. Under influence from the United States and NATO (specifically an exchange of pledges between George Bush and Turkish Prime Minister Suleyman Demirel), Turkey agreed to expand aid to this region. Under George Bush, U.S. companies were encouraged to find Turkish partners with whom to do business in Central Asia. Bush wanted Central Asia to emulate a Turkish model of a democratic and secular state. This appeared to be the only way to preserve the status quo and to utilize Turkey in the process as a pawn to preserve peace and stability in the region.

In reality, Turkey had already became the ideal dream country for the Central Asian elite. It was westernized, close to the Americans but still Islamic and Turkic, and in whole, it offered exactly what the nomenklatura wanted. They (Central Asians) believed Turkey could provide all the above and a perfect access to the West. They believed by using the "Turkish card" that they could prove to Moscow that they had a powerful foreign patron. It also indicated the ability to diplomatically make foreign policy decisions without Moscow's interference.

Turkey intended to placate Russia by negotiating with nine other countries in the formation of a Black Sea Economic Organization. Turkey, Azerbaidzhan, Ukraine, Bulgaria, Romania, Armenia, Georgia, and Moldova signed the accord on 25 June 1992

in Istanbul. This accord gave Turkey a pre-eminent role in the region. Turkey had attempted to play a role in the resolution to the Armenia/Azerbaidzhan conflict, but its current military and economic aid to Azerbaidzhan made such a role dubious in the eyes of Armenians.

By 1993, many Central Asian leaders were losing hope of Turkey's ability to deliver economic benefits due to a lack of Turkish investment and industrial promotion. At this point, Islamic fundamentalists promoted the idea that "Turkey was just a stalking horse for the Americans, who wanted to deprive Central Asia of its Islamic heritage and valuable oil"[59]. The leaders of Central Asia soon realized that what was best in the interest of the West was not really beneficial to them.

During 1992, Iran and Turkey faced off against one another in a continued rivalry to facilitate the rights for oil and gas pipelines in this region. Armenia, in 1993, requested gas from Iran which was supported by Russia to thwart the influence of Turkey in Azerbaidzhan. Soon after, Russia encouraged Turkmenistan to build closer ties with Iran. Iran insisted during this entire episode that they had no political interest in supporting Islamic groups or becoming involved in these states' domestic politics and economies, but in fact, this was exactly the outcome[60].

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[59]Ahmed Rashid, The Resurgence of Central Asia: Islam or Nationalism (Great Britain: Oxford Univeristy Press, 1994), pp. 210-212.

[60]Rashid, p. 213.

There are numerous rivalries between all the states of Central Asia. The wealth of the "north" versus the growing impoverishment of the "south", along with numerous local ethnic and political problems, could very well split the Central Asian states prior to a consensus on forming a stronger economic union. In addition, a collective Central Asian compromise on the direction of foreign policy is necessary for future stability. Currently, the Tajiks demand the return of their cultural centers of Samarkand and Bukhara from Uzbekistan, Turkmenistan had disputes with Uzbekistan over water rights, while Uzbekistan demands the return of the Uzbek-majority regions of Khodjent from Tajikistan and Osh from Kyrgyzstan. The borders established during the Stalin era are potential catalysts for future conflict at both a political and ethnic level. At present, there are estimated eighty potential border disputes simmering in the former Soviet Union. The mechanism needed for a possible resolution does not appear to be in any future compromises.

The solution to a multi-dimensional foreign policy can only be achieved when the Central Asian states settle their myriad of inter-ethnic problems, border disputes, petroleum/exploratory rights, and appropriate infrastructure to exploit oil reserves. A large part of the problems stem from the utilization of minorities in one another's territory in order to gain political advantage. I am convinced the Central Asian people need assistance in democratic reform (e.g., empowerment through the ballot box). New policies for foreign and domestic reform cannot

take root until power-hungry leaders decentralize governmental power. National and regional security for this volatile region rests with the improved structure of economic union and political cohesion. The rational choices for self-determination and ethnic harmony play a tremendous role for the future prosperity of the Central Asian states. The question of gaining petroleum independence along with indispensable oil export revenues will only be solved when the necessary foreign capital has been accessed through Western investment. This scenario depends greatly on the benefits and initiatives offered to foreign investment companies and the mutual cooperation with Moscow. The dependency linkage between the Central Asian states and Russia is the main source of tension and will be the determining factor of future economic security.

C. THE SIGNIFICANCE OF AN EFFECTIVE PETROLEUM POLICY IN BOLSTERING ECONOMIC CONFIDENCE

As mentioned earlier, the lack of formal petroleum policy poses serious threats to the future economic security of the former Soviet Union. The oil industry depends on export capital for survival. The aforementioned intrastate trade is only superficial for meeting the basic lower hierarchy of needs (e.g., fuel for heat, electricity, and transportation). The survival of the oil-producing states relies on international exportation, investment of excess capital in pipeline infrastructure, and the replacement of antiquated petroleum equipment.

Economic confidence will not be achieved until the financing of private oil firms can be accomplished by the companies

themselves which includes the decreasing role of government subsidization, providing a legal framework for honoring contracts and settling intrastate and interstate disputes, the unilateral acceptance of a joint economic union between all states, introduction of a universal oil-pricing policy which allows the former Soviet states to compete on the international market, and ultimately stabilize and reverse the trend of decreasing oil production back to the 1988 levels (12.5 million barrels/day). According to Yergin and Gustafson in Russia 2010: And What It Means for the World, the "drive for identity", a move by the independent oil states to place their state on the map as a significant oil producer, is the highest priority of the oil producing states. Without identity in the world market, the chances for survival within the Russian-dominated former Soviet Union are extremely limited by the decisions made in Moscow. The state of the Russian economy appears to be the driving force behind the rate of economic reform within the other independent states. In other words, Russian motives within the free market society must be established prior to the stability of each independent state.

According to the Oil and Gas Journal, four conditions are necessary in order to stabilize the Russian economy and the interstate/intrastate rivalries. The first is a political administration publicly elected with the legal groundwork for a justified division of power between president, parliament, and the judiciary. This system would be representative of all people

and empower the public in the state's destination. The bottom line to this condition is forcing the government to accept the doctrine of laissez-faire and allow more latitude towards public interest.

The second condition is the establishment of an economic community which favors a universal legal framework for handling state and international trade. According to A.E. Putilov, president of Rosneft, Russia's state oil enterprise, the crisis in the Russian oil industry can be overcome not so much by additional investment but by market relations. Many more guarantees for foreign investment are necessary but require the implementation of legislation (which is an extremely slow process). The legal framework must shape the industry before major changes can happen.

The third condition is the complete revamping of the Russian oil industry. This is a strategy endorsed by Oil and Gas Journal's David Knott who claims "the world oil industry's biggest challenge must be to reorganize Russia's oil sector"[61]. Since almost two-thirds of export revenues come from oil and gas, a loss of production or the inability to transport these hydrocarbon resources abroad translates into an automatic drop in foreign capital currently necessary for day-to-day operations. Reorganization of the oil sector is the most significant

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[61]David Knott, "Big Challenge: Reform Russia's Oil Industry", Oil & Gas Journal, August 8, 1994, p. 32.

condition necessary since state functions would nearly cease with the termination of oil flow.

The fourth condition is the continuation of efforts to attract foreign capital and to draw back Russian funds secured in foreign banks also known as capital flight. Russia must help itself through promotion of domestic capital investment in private enterprises. This will only be possible through the prevention of domestic capital flows out of the state.

Of all the conditions, why is the establishment of a stable petroleum policy the most critical element in bolstering economic security? The dependency on foreign revenues from oil is sufficient if considering a rentier state (one which derives the majority of its income from rents rather than the productive capacity of its citizens) but in the case of Russia, petroleum is only one of many production commodities. The other commodities would be competitive on the foreign market if they had the technology and mass production necessary for international competition. The answer to prosperity rests with the utilization of capital earned from oil revenues which must be reinvested for infrastructure (e.g., pipelines, roads, railways, revamped factories with Western technology, etc.). If revenues are not reinvested into the economy along with the modernization of production equipment, the economy will continue to show disastrous setbacks[62]. Once a petroleum policy can be

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[62]Oil & Gas Journal, "Russia's Oil and Gas Problems Continue to Ripple Through Economy", January 4, 1993, p. 32.

established which reflects the legal framework and political support from the entire bureaucracy, the groundwork shall be set to broaden markets and reinvest capital into a starving economy.

The Russian economy would immensely benefit by emulating a rentier state but lacks the technology and infrastructure to exploit the vast natural resources hidden below the surface of both land and sea. The possibility of evenly distributing wealth thoughout all segments of the population (e.g., developing a much larger middle class society) could very well enhance the legitimacy of the Yeltsin administration and bolster the state of the federation. If this was reality, the high capital available to the economy would require little to no taxation for developmental programs. The available capital would allow Yeltsin to purchase an economic and political security system which could further enhance stability and legitimacy[63]. Russia, however, does not have the means nor the desire to equally distribute state assets to the public. For this reason, the impediments to privatization and capitalistic ventures can be directly related to the desire of the state to control capital investment and ultimately the oil industry.

D. OIL CONTROL: WHAT IT MEANS FOR RUSSIA AND THE INDEPENDENT STATES

What is meant by oil control? Oil and gas are valuable commodities which can afford a more stable economic lifestyle for those states which can produce and market such resources on a

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[63]Robert W. Stookey ed., The Arabian Peninsula, Zone in Ferment (Hoover Institution Press, 1984), p. 25.

grand scale. The control of oil involves who owns the reserves, who owns the right to market the reserves, who receives the revenues, and who has the contract to develop the oil fields. Control is directly related to the right to legally or wantonly exploit the oil or gas for financial gain. The reasons for desiring control may be different for each party participating in the conquest, but the ultimate goal is potential economic gains.

This is evident to all the private oil companies which rely upon one product for survivability. The goal for individual states may differ with respect to control. The United States for instance desires a majority of domestic consumption to be supplied by domestic production. In addition, the U.S. cannot afford to depend upon foreign oil as a major source of its oil without introducing assurance guarantees which will protect the national interest. The Gulf War is evidence of that desire to permit the flow of oil out of the Middle East. Economic warfare such as the Arab oil embargo of 1973 exemplifies the significance of the ability by certain countries to restrict the flow of oil and control the oil weapon[64].

Russia, on the other hand, desires to control not only the production and distribution of its domestic oil but also the oil of the former republics[65]. The Russian invasion of Chechnya is

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[64]Daniel Yergin, The Prize: The Epic Quest for Oil, Money, and Power (New York: Simon and Schuster, 1990), p. 631.

[65]Stephen J. Blank, "Energy and Security in Transcaucasia", Strategic Studies Institute, U.S. Army War College, September 7, 1994, p. 2.

not an isolated instance of repression for the intention of maintaining the Russian Federation, but instead a wielding of power to control the access to oil flowing out of the Caucasus through Grozny and ultimately Moscow. President Yeltsin claims the goal in Grozny is "to restore constitutional order" which is the job of the counterintelligence service (successor to the KGB Second Directorate), but in reality, the counterintelligence service job description of "defending the constitution" has long been a euphemism for police suppression of political dissent. The war on Grozny "serves the Yeltsin administration by giving a message to other non-Russian ethnic groups, including those of the newly independent states" (especially the ones with independent oil interests) "that Moscow will not hesitate to use violence in the face of recalcitrance"[66]. The situation almost exhibits signs of former communist xenophobic practices. This contentious situation is difficult to predict for future implications, but one thing is for certain: where oil and gas are involved within the confines of the FSU borders, the battle for control or influence of these resources will not be easily attained without the use of force, threats, or economic leverage.

The control over oil and gas resources is the most potent leverage available to Russia in order to carry out its national interests. Military force, unlike that under Soviet control, can

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[66]Amy Knight, "The Real Winner in Chechnya: The K.G.B.", The New York Times, February 2, 1995, p. A-17.

no longer be justified for intervention in intrastate conflict[67]. Russia has been able to advance its own economic security interests under the auspices of peacekeeping activities in regions of internal conflict (e.g., Tajikistan, South Ossetia, Moldova, Abkhazia and Nagorno-Karabakh). The new role for Russia as the successor to the Soviet Union allows government officials to do little to disguise Russia's less than neutral intentions in the near abroad[68]. This is not unusual when considering that many Russian officials in the military consider the former Soviet borders to coincide with those of Russia.

Moscow has asserted its control by ensuring that states such as Azerbaidzhan and Kazhakstan cannot transport oil without utilizing the vast network of Russian pipelines. Without Moscow's permission for building new non-Russian pipelines across any Russian territory, the respective independent states must sign a contract granting a certain percentage of all revenues be

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[67]The Soviet Union could justify intervention within the republics when they were part of the union, but today discretion of the international arena must be contemplated with respect to possible sanctions. Peacekeeping forces became the avenue the Russians forces would exploit in order to express its new form of control. This was the most opportunistic way for Russia to implant occupation forces, with the lack of a U.N. Security Council directive in place within the FSU, Russia could carry out operations as desired.

[68]See paper written by Dr. Elaine M. Holoboff for the Conference on Multilateral Security: Eurasia and the West sponsored by the Russian Littoral Project, Kings College, London and the International Institute of Strategic Studies, October, 1994, p. 8.

sent to Moscow[69]. Russia's position in the Nagorno-Karabakh war is now changing (toward an Azeri solution) due to the desire to ensure a new pipeline structure is built in their favor (vice a Turkey or Iran pipeline structure)[70]. The trend appears to be that Moscow will utilize any political weapon within its arsenal in order to exploit the vast reserves of oil outside the Russian borders.

Another example of the economic power of oil is the petroleum dependency of Ukraine on Russian oil. In the spring of 1994, Kiev owed Moscow $3.2 billion for oil and gas imports. Moscow threatened to shut down oil deliveries as a threat to gain a strategic position of economic power over Kiev's dependent economy. A prime example of Moscow's subversive attempt to gain a dominant position over Kiev occurred in June of 1993:

> *President Yeltsin decided to play the 'oil card' in order to obtain concessions on the Black Sea Fleet; subsequently after numerous threats, Moscow shut off oil and gas supplies for several days*[71].

The same action was taken against Belarus in 1993 for failure to pay gas debts.

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[69] e.g., Moscow coerced Azerbaidzhan into a 10 percent share of oil revenues due to the control wielded over the Azeri pipelines through disposition of its petroleum at terminal points in Russia.

[70]See "No Way Out", The Economist, May 28, 1994, pp. 92-93. A new pipeline is being considered for an outlet to the West via the Black Sea. Turkey and Iran each have separate solutions for a pipeline to pass through their territories which would inevitably give them an upper hand in the regional petroleum business.

[71]"Out of Gas", The Economist, March 12, 1994, p. 291

Russia has the way and the means to subvert most of the independent states. Should it be any surprise that Moscow is using Soviet tactics to coerce an economic union of the FSU under Russian control? From the evidence presented, a common economic union would most likely benefit most of the independent states and foster a better environment for capitalist ventures, but the sole concern for the independent states is the manifestation of sovereign ideals and the removal of Moscow's influence. Power-politics will be the name of the game for the near future. Unlike under communism, the former republics do have alternative sources of assistance outside of Russia. The independent states will only gain power and economic influence by bolstering intrastate and interstate trade through taking advantage of their resources available and gaining Western capital investment for infrastructure and technology. Oil is that commodity which will attract Western investment and bolster economic confidence.

The oil and gas business is no longer a regional business and takes on a global perspective which affects all countries that produce or consume petroleum products. Oil and gas have a greater impact on national security than any other global commodity. The Persian Gulf War illustrates the essential position of oil in the global balance of power. The position of FSU oil within the realm of the world economy has not yet been contemplated with respect to its significance and its position within this balance of power. What if the former Soviet republics collectively decided to suspend all petroleum

exports? The result would be a modest decrease to world petroleum supplies but a devastating effect on the economies of the independent states. This scenario is not very realistic but the implications are quite apparent. The decrease in FSU petroleum production which has been cut in half from the levels of 1988 is an omen to the fate of the petroleum industry. If steps are not taken to preclude a massive collapse of this industry, the result may be a massive security issue for the entire world.

The last decline (prior to 1989) of Soviet oil production occurred during the mid 1980's and resulted with a substantial infusion of capital from the central government. Internal funding is no longer available. Solid increases of investment are necessary to alleviate the problems facing the FSU petroleum sector. Russia must be the focal point for modifications. Moscow influences the disposition of over 85 percent of all oil and gas produced in the FSU[72]. The independent states must be included in the solution, but their political and economic weakness prevent the introduction of true reform. Besides, the United States and its allies have given the Yeltsin administration the sole attention for initiating reform policies. Meaningful Russian economic reforms[73], political stability[74],

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[72]David Yergin and Joseph Stanislaw, "Oil: Reopening the Door", Foreign Affairs, Volume 72, Number 4, September/October 1993, p. 86.

[73]e.g., capital investment in the petroleum industry

[74]e.g., shifting from centrist to the right

and a reliable legal framework for trade and investment[75] are prerequisites to Western investment in the Russian oil sector.

Russia currently lacks a market pricing system. The government pays oil producing amalgamations around 28 cents per barrel of oil produced[76]. This extremely low price creates serious problems for the petroleum sector due to the inability to pay competitive wages for workers and capacity to buy spare parts and necessary upgrades. Inflated prices for petroleum are passed on to the consumer who is probably just as poor as the state.

This "catch 22" situation requires innovative solutions. Only the West is capable of providing the necessary capital and technology to initiate a solution. This requires a modest relaxation of political and economic barriers to investment[77]. Investment will spawn better oil prices due to a much improved infrastructure. The increase of national oil prices and workers' wages will augment the money in circulation and bolster public confidence. Spending will inevitably increase and the oil industry will be the major benefactor.

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[75]e.g., issuing presidential decrees which promote capitalistic growth such as rewards and tax incentives for private industrial investment and entrepreneurship; and eliminate decrees which are primarily graft.

[76]"Soviet Oil and World Prices", Committee on Energy and Commerce, House of Representatives, December 11, 1991, p. 16.

[77]Tax codes must be changed to help attract more transnational oil companies. Revenue sharing must reflect a more impartial split of windfall. Political barriers such as presidential decrees in effect which place many restrictions on foreign companies must be relaxed.

The FSU estimated oil reserves are considered to be comparable to those of the Middle East. In order to exploit these vast reserves, foreign investment could make a very significant difference. It is estimated that $50 billion is necessary between now and the year 2000 in order to stabilize Russian oil production at its current levels (6.5 million barrels/day)[78]. The possibility for oil production to fall below 4 million barrels per day is possible if foreign investment is not sought. This would be disastrous for the Russian economy. In order to revert production back to the levels of the late 1980's, it is estimated another $50 to $70 billion dollars of investment is required; Russia does not nearly have the resources available to cover such a heavy burden[79]. For this reason, foreign investment from Western oil companies and governments is essential for economic recovery and bolstering public confidence.

Russia craves foreign investment but is hampered by the opposition by many Yeltsin supporters who despise the thought of depending upon the support of a former adversary. Many Russians only desire Western influence on their own terms. If this is the ideology of the Russian bureaucracy, transnational oil companies will take their business elsewhere such as the highly promising

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[78]Ian F. Elliot, The Soviet Energy Balance (New York: Praeger, 1993) p. 72.

[79]Daniel Yergin and Joseph Stanislaw, "Oil: Reopening the Door", Foreign Affairs, Volume 72, Number 4, September/October 1993, p. 87.

reserves of the newly independent states of Azerbaidzhan, Kazakhstan, and Turkmenistan (which is already the case for Chevron and Amoco oil companies). Tensions could grow exponentially between Russia, the independent states, and the Western consortiums. This provocative situation could eventually involve Western security institutions (e.g., CSCE, UN). The bottom line is each party must make concessions in order to promote the interests of all parties. Cooperation through international negotiation and multilateral contracts will be the only way to foster an environment of esprit de corps.

Russia will be able to bolster economic confidence provided the petroleum sector is singled out as a major component of future economic security. The risks involved for Western investment in the petroleum sector are high, but the potential returns far outweigh these risks. With supplemental insurance guarantees granted to the transnational oil companies, the rate of investment will grow in time. The future beholds a massive fortune for those who take the risk and invest in the future stability of the Russian petroleum sector.

IV. UNITED STATES' NATIONAL INTEREST WITH RESPECT TO RUSSIAN PETROLEUM PROSPECTS

A. THE ROLE OF POLITICS IN FORMULATING UNITED STATES' ENERGY POLICY

Since the oil shock of 1973, most industrialized nations have come to accept energy security and economic security as key components of national security. Daniel Yergin, author of *The Prize*, suggests that "the objective of energy security is to assure adequate, reliable supplies of energy at reasonable prices and in ways that do not jeopardize major national values and objectives"[80]. These supplies that Yergin refers to have for the first time in history dropped below fifty percent from domestic production. Consequently, the United States now depends more on foreign oil than can realistically be supplied by domestic producers.

From a historical view point, the United States during the 1950's produced roughly half of the total world's oil. This is twice as much oil as the Middle Eastern and North African oil states produced in combination. By the late 1960's, the U.S. surplus production had disappeared, and between 1967 and 1973, oil imports rose from 19 percent to 36 percent of total U.S. oil consumption. The U.S. production figures have decreased by almost 50 percent since 1967, while consumption figures have consistently increased from 1.5 to 2.0 percent annually. James Schlesinger, chairman of the Atomic Energy Commission in 1972,

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[80]Daniel Yergin, "Energy Security in the 1990's" Foreign Affairs, Volume 67 (Fall 1988) , p. 111.

demanded the promotion of energy conservation for reasons of national security, and environmental improvement, but few people were convinced of an impending crisis[81]. Within a year, the Arab oil embargo would magnify the significance of a desperately-needed national energy policy in order to protect U.S. national interests.

The result of this national energy challenge was the establishment in 1975 of fuel efficiency standards and the 100 percent enlargement of strategic petroleum reserves. In April 1977, President Carter stated:

> *Our decision about energy will test the character of the merican people and the ability of the President and Congress to govern the nation. This difficult effort will be the moral equivalent of war, except that we will be uniting our efforts to build and not destroy*[82].

As we observe today, the policies placed forth at this time (ie. reducing imports by eliminating price controls on U.S. domestic oil and promoting energy conservation) have not thoroughly been supported by members of Congress and the President due to the absence of impending crisis or lack of willpower.

In 1980, the Rapid Deployment Joint Task Force was established as a response to the Soviet invasion of Afghanistan and to enhance the military contribution to energy security with respect to maintaining open shipping lanes in the Persian Gulf. The Defense Department Report for fiscal year 1981 sums this up

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[81]Daniel Yergin, The Prize: The Epic Quest for Money, Oil, and Power (New York: Simon and Schuster, 1991), p. 567

[82]Joseph J. Romm, Defining National Security (New York: Council on Foreign Relations Press, 1993), p. 38.

very well:

> *With time and a reduction in our standard of living, we could forgo or substitute for much of what we import. But any major interruption of this flow of goods and services could have the most serious near-term effects on the U.S. economy. In no respect is that more evident than in the case of oil. A large scale disruption in the supply of foreign oil could have damaging consequences for the United States as the loss of an important military campaign, or indeed a war. Such a disruption could be almost fatal to some of our allies. It is little wonder, in these circumstances, that access to foreign oil constitutes a critical condition of U.S. security*[83].

Due to projects aimed at energy efficiency during the Carter administration, the U.S. was able to save 13 million barrels of oil per day ($150 billion savings/year) by the mid-1980's. Oil imports in 1977 constituted 46 percent of total U.S. consumption. This figure dropped to 28 percent by 1982. The energy policies in place during the Carter years were almost reversed 180 degrees during the Reagan administration due to the abundancy and relative inexpensive petroleum during the 1980's. Federal funding for energy conservation was cut back by 70 percent, and funding for solar and other renewable forms of energy was cut by 80 percent. These cutbacks stemmed mainly from the desire for private industry to thrive without added precautions and internal overhead costs. By 1990, oil imports had increased from 28 percent to almost 50 percent which accounts for almost half of our $100 billion trade deficit[84]. These is significant since our national debt, hyper-inflated spending, and lack of cash flow

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[83]Romm, pp. 38-39.

[84]Romm, p. 40.

from the internal markets could eventually create a severe recession. The military energy program which entailed spending billions of dollars each year to protect the flow of oil was kept intact by reflagging Kuwaiti oil tankers and providing a naval presence in the Persian Gulf as a strategic measure of our support for this region[85].

The short duration of an energy concern during the Iraqi invasion of Kuwait (oil shot above $40 per barrel on the internationl market) did not seem to warrant a higher profile on energy policy following the Iraqi War. This would appear to be the same hypocrisy practiced by past administrations. The concern of the Bush administration was real but consequential action was soon dismissed due to domestic economic problems. I believe this inaction inevitablity became a major mistake. At the time of the gulf crisis, President Bush made the following statement:

> *Our jobs, our way of life, our own freedom and the freedom of friendly countries around the world would all suffer if control of the world's great oil reserves fell into the hands of Saddam Hussein" and "we cannot allow any tyrant to practice economic blackmail. Energy security is national security, and we must be prepared to act accordingly*[86].

The United States, like most industrialized states does not contemplate an energy crisis unless one is imminent, or it threatens our national security. Joseph Romm states the

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[85]Daniel Yergin, The Prize: The Epic Quest for Money, Oil, and Power (New York: Simon and Schuster, 1991), pp. 765-766.

[86]Quoted from "Bush Says Iraqi Aggression Threatens Our Way of Life", New York Times, August 16, 1990, p. A-4.

underlining problem quite succinctly in his book *Defining National Security*: new threats to U.S. national security including nonmilitary matters such as economy, energy, the environment, and drugs, are not adequately addressed by America's existing security paradigm. Romm suggests that the term "national security" be redefined for the post-Cold War era.

Many economists agree that political considerations are frequently a barrier to rational energy policy. The problem stems from reactive policy by Congress and the President. They appear to be driven to action by catastrophic events and the media attention of those events[87]. This is evident by the previous quote of George Bush concerning energy security as synonymous with national security during the Gulf War.

Prior to 1970, U.S. "national security" referred almost exclusively to military security. The primary threat was from "external threats to the American way of life". The spread of communism and its threat to democratic idealism would be the major component to jeopardize national and international freedoms. In 1947, when the National Security Act established the National Security Council, the function of this body of government was stated as follows: "to advise the president with respect to the integration of domestic, foreign, and military policies relating to national security"[88]. The definition of

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[87]Congress and the Nation, Volume VIII, pp. 417-495.

[88]Quoted from Joseph J. Romm, The Once and Future Superpower (New York: William and Morrow and Co., Inc., 1992), p. 42.

national security was purposely left open ended in order to accommodate new threats to our national security. According to Secretary of State Dean Acheson in 1947, the goal of national security policy might be military in nature (containment of the Soviet Union) but the means would include numerous nonmilitary measures[89]. By the late 1940's, economic measures would be the main weapon to enforce a policy of containment with a simple but effective nuclear arsenal as the primary deterrent[90]. This came in the form of the Marshall Plan, a foreign aid program for rebuilding Europe after World War II aimed at thwarting the spread of communism. The United States also used export controls via a committee with NATO allies called CoCom, Coordinating Committee on Multilateral Export Controls. This organization was established to restrict exports of sensitive technology to the Soviet Union and Warsaw Pact countries. At this time the threat from the USSR was top priority, so economic security was taken for granted and the policy of containment would drive our national security policy for the next forty years[91]. The energy crisis of 1973 would be the first time the U.S. national security would be threatened at home by an economic war waged by the oil-producing states of the Middle East. Fortunately, the threat

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[89]Romm, p. 43.

[90]The historian John Lewis Gaddis expresses the U.S. government "decides to rely on economic rather than military instruments of containment in the late 1940's". "American Historical Review Forum", April 1984, p. 383.

[91]Robert Kuttner, The End of Laissez-Faire (New York: Alfred A. Knopf Publishing, 1991) pp. 197-209.

from the Arab oil embargo was not as damaging as was originally believed, but the U.S. realized the extent of its vulnerability with respect to a lack of unlimited oil supply. Dependency on oil was not a position that the U.S. could afford while still competing with the Soviet Union for world influence.

By 1975, the U.S. Congress would heed the words mentioned earlier by James Schlesinger and produced a similar response:

> *the urgency of the nation's energy challenge will require commitments similar to those undertaken in the Manhattan and Apollo projects*[92].

When President Ronald Reagan took the helm in 1981, the nonmilitary energy policy was eliminated and environmental regulations were relaxed. Energy security from this point diminished as our dependence on foreign oil increased. Economic, energy, and environmental security suffered throughout the 1980's at the expense of military security. The policies of this era were quick fixes and lacked any directional thought for the future. The need for a focused national security policy was replaced by whims and zealous governmental spending.

With the end of the Cold War, a new era is dawning upon U.S. security concerns. The military threat has transformed into a greater economic threat involving the dependency on foreign petroleum and the inability to control the rate of energy conservation domestically. The Persian Gulf War explains a great deal concerning the threat of OECD countries (except for U.S. and

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[92]Quoted in Ralph Cavanagh, "National Energy Policy", World Policy Journal, Spring 1989, p. 242.

Canada) relying upon one region for indispensable oil imports. Geo-economic power is becoming the strategic advantage over the dying competitiveness of geo-strategic military power. Since the demise of the Soviet Union, the meaning of national security has hopefully inaugurated a quest for a new stable world order. For instance in 1991, Theodore Moran, director of the Program in International Business Diplomacy at Georgetown University's School of Foreign Service, listed six primary areas for U.S. National Security Policy in the 1990's. They are as follows:

> *Encouraging stability and reform in the Soviet Union"* (my first premise for Russian economic security through oil and gas policy reform), *"maintaining a cooperative U.S.-Japanese relationship, avoiding vulnerabilities from the globalization of America's defense industrial base, reducing dependence on oil from the Persian Gulf"* (my second premise which consists of augmenting U.S. oil imports by exploiting the vast explored and unexplored oil reserves in Russia), *"moderating the impact on the Third World of the prolonged debt crisis, and limiting the damage from narcotics trade*[93].

These areas of concern are not all inclusive, but they cover the primary basis for security policy to be formulated. This brings us to the question of how the U.S. Congress can formulate energy policy and what are the conditions necessary to persuade Congress to acquiesce and implement a comprehensive policy which satisfies national security into the next century?

The special relationship between the oil industry constituency and Congress through the past fifty years has been very profitable for the oil companies due to the oil depletion

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[93]Quoted from Theodore Moran, "International Economics and National Security", Foreign Affairs, Winter 1990/91, p. 74.

allowance established in 1950. The allowance permits oil producers to deduct up to 27.50 percent (22 percent since 1969) of their gross income prior to subtracting other deductions in computing their taxable income. The rationale for this exemption is that as the supply is used up, oil becomes more scarce and much more difficult to discover and develop. The depletion allowance is surmised to be an incentive to encourage new exploration. The actual success of the oil interest group will be analyzed here in order to measure the impact of interest aggregation vis-a-vis the policy area. A comprehensive insight into the oil industry's political antics will be focused upon for a cross-sectional view of the possible support within Congress for energy policy reform.

Although the oil industry has gained financially in the last fifty years, the oil industries have lost congressional support consistently from the end of World War II up to 1990. The policy issues initiated by President Truman (e.g., to reduce drastically the oil depletion allowance) was the first attack to reduce the influence of "petro-politics" within congress[94]. From this point, the executive branch from each consecutive administration would attack the special incentives for oil exploration. Up to the present day, the incentives have diminished (e.g., oil depletion allowance, development of alternative fuel sources, and fewer tax breaks for environmental safety developments) while

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[94]Bruce Ian Oppenheimer, Oil and the Congressional Process (Lexington, MA: Lexington Books, 1974), p. 27.

restrictions have increased dramatically (e.g., environmental standards and restrictions on locations of drilling and exploration). The result of these policy changes has placed the oil industry in a detrimental position for future prosperity. U.S. economic security has benefited since the oil industry's move to exploit foreign reserves (posing fewer restrictions and a much higher financial gain).

The constituent strength of the oil industry must be examined in the House and Senate in order to grasp the influence of this particular interest group. Both houses of Congress are neither the first nor the last point in the decision making process, but their high visibility places them at the forefront of political change. Initially, the operationalizing of oil interests within Congress with their constituencies must be scrutinized.

A total of thirty-three states produce oil or oil products, but fifteen of these states produce 97.50 percent of the total U.S. domestic production[95]. These states are the only states with significant oil interest within the congressional process. Of these fifteen states, we can legitimately conclude that at least thirty senators have oil interests in their constituency. Including the Senate and House of Representatives, there are approximately 84 votes in favor of oil constituents; this interest is equal to about 25-30 percent of the membership. From

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[95]"The Oil Producing Industry in Your State", Independent Petroleum Association of America, 1989, p. 18.

these figures, we can deduct that a minority of less than one-third of congressional membership has an interest in the oil-industry constituency. In other words, any legislation which benefits the oil constituents would have approximately 25-30 percent support in both houses. The following is provided in order to operationalize the definition of a constituency petroleum interest: (provided from the Mineral Yearbook 1966)

> *Districts were considered to have a petroleum interest if (1) the value of petroleum produced in that district exceeded five million dollars; (2) two million barrels or more of crude petroleum were produced; or (3) the Yearbook credited the county with active exploration*[96]

The figures here are arbitrary but the generalization gives evidence of a constituency support for oil industry to be much less than the majority rule for passing legislation. It must also be taken in consideration that the top four oil producing states account for over 76 percent of total domestic production (this would include over 82 percent including the current Alaskan oil production). If these figures are utilized for estimating congressional oil interests, then only 8 percent of the Senate and 13 percent of the House would share an interest in oil production legislation. The oil industry has had constituency-related ties of 25-30 percent of the House and Senate membership which is far from enough strength to win floor votes unless a large percentage of the other members are absent or can be persuaded to vote for the maintenance of oil industry incentives

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[96]Quoted from Bruce Ian Oppenheimer, Oil and the Congressional Process (Lexington, MA; Lexington Books, 1974), p. 19.

(e.g., the oil depletion allowance)[97]. This brings us to the question of where has the support come from and why has that influence been bolstered drastically since 1990?

The increasing support of the oil industry can be attributed to two major events: (1) the first time in U.S. history where domestic oil production accounts for less than 50% of total petroleum consumption (directly related to U.S. dependency on foreign oil imports); and (2) oil companies are forced to shut down production and forestall exploration when price controls are not instituted by the federal government. When oil production decreases as much as it has in the U.S. since 1989 (25% total to date)[98], the government and national security suffer also. The government does not collect taxes or royalties on revenues, rents and bonuses from federal acreages, and corporate taxes from bankrupt companies. The higher taxes paid by oil companies due to a lower oil depletion allowance is the prime demotivator for revitalized exploration and investment in transnational oil ventures. Meantime in March 1994, the U.S. Senate energy committee reported a modest U.S. oil industry relief bill which would provide producers a royalty holiday for new deep water production until the capital costs are recovered. This amended the 1990 Oil Pollution Act (OPA) helping independent producers operate offshore by certifying $150 million financial

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[97]Oppenheimer, p. 20.

[98]Patrick Crow, "Efforts to Assist Domestic Oil Producers", The Oil and Gas Journal, Volume 92, Number 9, February 28, 1994, p. 23.

responsibility by the federal government and allowing the reduction of OPA's requirement for financial responsibility based on the risk of oil spills[99].

The U.S. oil and gas industry is making political progress and congressional sympathy for slumping oil prices and decreasing production. The industry's main focus has been tax relief and not price support. The Oil and Gas Journal commends this strategy since their view is that price support will never occur in the U.S.; and besides, low oil prices help more voters than they harm[100]. In February 1994, 34 oil-producing state senators and representatives met to discuss ways to assist producers. The discussion focused on tax relief for marginal production. Further legislative process will depend on the industry's ability to persuade the House and Senate members of an impending crisis. Producers must pursue relief in the context of immediate national concerns: jobs, economic activity, federal revenues, national economic security, and dependence on foreign oil. Success at the level of practical politics will advance the deeper message by the following implication: national interests are linked with the ability to produce oil and gas. With the help of President Clinton, emergency legislation could pass this year but not comprehensive tax relief legislation. According to former Senator David Boren (D-Okla.) architect of the "Energy Summit",

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[99]"U.S. Senate Energy Committee Reports Out a Modest Oil Industry Relief Bill", The Oil and Gas Journal, Volume 92, Number 11, March 14, 1994, p. 2.

[100]The Oil and Gas Journal, December 17, 1994, p. 21.

oil production has declined 25% in the last five years;

> *the oil industry is in a free fall where emergency assistance is justified, just as it was for a natural disaster in the California earthquake (1994). One of our problems is that this is not an issue except in Texas, Louisiana and Oklahoma, I don't think the rest of the country realizes there is a problem*[101].

Many oil-state members of Congress have pointed out that real crude oil prices have fallen to the lowest point in twenty years, but most others see this as an added incentive for consumers and constituents. The time has come for Congress and the current administration to put forth a domestic energy policy which recognizes the national security interest and the inherent problems of our domestic energy industry. This would also include a policy which places the U.S. in a more favorable position to help ease global dependence on imports of Middle Eastern oil. A major step towards accomplishing such a goal would be to extend technical assistance to help restore Russian oil production which would expedite economic recovery. Fortunately, the U.S. Congress is in the process of contemplating FSU foreign assistance with respect to the energy sector. Twenty-one members of the House of Representatives have formed a caucus, the Congressional Institute, to promote energy trade between the U.S. and the CIS. The caucus is compelling the government to devise a strategy for more effectively penetrating the former Soviet Union energy market. Congress must ponder the

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[101]Quoted from Patrick Crow, "Efforts to Assist Domestic Oil Producers", The Oil and Gas Journal, Volume 92, Number 9, February 28, 1994, p. 23.

significance of CIS crude in order to define the future of U.S. national interest. Representative Greg Laughlin addresses this topic quite appropratelly in a speech to the International Trade Commission (ITC),

> *Energy holds the key to successful transformation of the FSU from a socialist to a free market economy; the development and export of FSU oil and gas is in the U.S. interest because it will ease world dependence on Persian Gulf oil*[102].

This brings us to another question: what will the role of Russian (and FSU) oil be in defining U.S. national interest?

B. THE ROLE OF RUSSIAN OIL IN DEFINING UNITED STATES' NATIONAL INTEREST

Before the actual role of Russian oil can be contemplated, the significance of foreign oil must be established relevant to the United States national interest. While the U.S. represents just 5 percent of the world's population, it consumes almost 30 percent of the world's oil[103]. The U.S. also imports just over 50 percent of its current oil needs, and domestic reserves now account for less than 2.5 percent of the world's proven reserves. Russia, on the other hand, has almost 6 percent of world proven reserves and astronomical unproven reserves[104]. The USSR would never have been able to attain its superpower status without the development of its immense oil and gas complex. After the development of the West Siberian oil and gas, the USSR oil

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[102]Crow, p. 46.

[103]Phil Kuntz, "Unstable Mideast Oil Supply Rocks the World Market, Congressional Quarterly, January 5, 1991, p. 21.

[104]National Petroleum News, June 1993, p. 21.

production doubled between 1971 and 1988; gas production increased by more than 7.5 fold; this accounts for almost 20 percent of world production of oil and 40 percent of the world production of gas (1988 figures). At this time, the Soviet Union was the number one oil and gas producing country (OPEC produces much more oil but not when divided by individual countries). This should give a clear perspective of the undeniable potential of vast Russian oil and gas reserves.

Now on the darker side, Russia is battling a severe economic crisis which includes: a drop in industrial production by a factor of two, the cleavage of economic relations between CIS countries, the loss of the regulatory role of the state in the economy, and a decay of the geological service[105]. All of these occurrences have caused a sharp decline in the production and consumption of oil and gas since the demise of the Soviet Union (from 12.5 million barrels/day in 1988 to 7.0 million barrels/day in 1994). To date, all economic reform directed at the oil and gas industry has failed and requires technological assistance and capital only possible through Western investment or capital reinvested from within the former Soviet Union[106]. The latter is not possible without oil export revenues which are dimishing on a

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[105]"Oil Export Policies Threaten Future Economic Development", FBIS-USR-94-050, Moscow Nezavisimaya Gazeta, April 19, 1994, pp. 4 and 42.

[106]Currently the available capital from within Russia is not available. Much of the revenue from oil is lost through "capital flight". This money is basically worthless while standing idle in Swiss banks and other reputable Western banks.

daily basis.

Oil can be viewed today as a single global market where production deviation can have a colossal effect on prices and availability. When the prices rise in one region of the world, the price will also increase across the globe. It really does not matter where the oil originates or how much is imported. The amount of oil controlled by the originator (exporter) is the bottom line indicator for controlling the price. This was a factor in the 1973 Arab oil embargo and more recently when the price of crude oil vaulted from 20 dollars per barrel to just over 40 dollars per barrel after the Iraqi invasion of Kuwait.

The national security of the United States currently depends a great deal on the volatile regions (with respect to open sea lanes) of the Middle East, the former Soviet Union (with respect to oil dependency), and the possibility for exploitation of the latter's inability to promote energy reform. The Middle East, besides bearing a heavy cost to the U.S. in foreign aid and military security through Persian Gulf naval forces, is developing an upper hand on the increased U.S. dependency on OPEC oil (U.S. receives 50 percent of imported petroleum from the Middle East). For this reason, any financial advisor in his right mind would suggest that the United States either diversify its dependence on foreign oil or drastically reduce domestic consumption which is not very likely with an annual increase of almost 2 percent. Energy needs, oil dependency, and the fragile economic balance of price controls, present intricate global

issues. The threat from oil dependency to U.S. national security may not appear to be an imminent crisis to most members of the U.S. Congress, but certain indicators (such as oil import figures and domestic production and consumption) should raise a flag to the immediate economic consequences. The changing nature of the oil threat tenders U.S. national security challenges which are not always apparent to those caught up in domestic legislation. The National Energy Strategy enacted in 1991 by the Bush administration was primarily aimed at reducing the U.S. dependency on Middle East reserves[107]. This policy met the perceived threat of oil dependency, but the policy inaction (e.g., major conservation acts) was only ideas which never became reality. Since the reduction of U.S. petroleum consumption does not appear to be in the cards any time in the near future and dependency on foreign oil is a reality in 1995, diversification of oil imports will be an essential policy consideration within the next few years. This is why the need to build up the oil industry (with guaranteed dividends) within the former Soviet Union is of a critical nature to the national security interests of the United States. For this reason, economic security is becoming much more significant than the once formidable military doctrine necessary for countering the Soviet arsenal and containing the spread of communism.

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[107]"The National Energy Strategy", Hearing before U.S. House of Representatives, 102nd Congress, First Session, October 16, 1991, p. 7.

Congress is currently debating the key emphasis for energy security. One viewpoint sides with the National Energy Strategy, which favors continuing the supply-side approach[108] to energy strategy (including the military energy policy), and the other viewpoint stresses energy security strategy that includes a strong nonmilitary component based on demand reduction[109]. The Russian option (where the U.S. provides foreign aid, technology, and transnational oil exploitation) along with additional conservation policies provide the most pragmatic solution to the energy security problem. The answer may appear simple but the process of capitalizing upon this solution will be an extensive task.

In order to take advantage of the massive Russian petroleum prospects, the United States does not have the pleasure to wait out the Russian political scene for stability. Whoever is sitting in the Russian or independent states' presidential seat does not really matter. We should be dealing directly with the position and not the person in that position. Now is the time to invest in the Russian (and CIS) oil and gas sector while it is still in a vulnerable position. If the opportunity is not taken,

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[108]Supply-side approach means the U.S. will be forced to produce a larger percentage of its domestic supplies while decreasing dependency on foreign oil which is almost impossible with the current consumption rate increasing by 2 percent each year.

[109]Joseph J. Romm, Defining National Security (New York: Council on Foreign Relations Press, 1993) p. 42.

there are many more countries who will jump at the chance to capitalize on a high risk/very high return venture.

The other disastrous and harmful situation for the West would be the consolidation of Russian (and FSU) and OPEC petroleum into an oligopoly which would be more powerful and dangerous than a military and economic superpower like the United States. This situation is not totally preposterous when considering a statement made by Victor Chernomyrdin in January 1994 where he announced Russia's interest in joining OPEC, only to retract the statement at a later date. Russia would rather wait until all oil in the FSU is consolidated under their own control before applying for OPEC. This would counter any efforts by the independent states (e.g., Azerbaidzhan and Kazakhstan) to apply separately once Russia had gained acceptance. According to Stephen Blank, Russia desires to gain power over the CIS prior to entry into OPEC which would give it a "monopolist role as the hegemon of the Commonwealth of Independent States' (CIS) energy economy"[110].

The U.S. has the technology, expertise, and the motive for reworking existing fields, finding new ones, and improving pipeline infrastructure in the former Soviet Union. The question is: how much risk is the U.S. willing to take to ensure the future economic security of the U.S. and reverse the possibility for the "second" demise (or revolution) of the former Soviet

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[110]Stephen J. Blank, "Energy and Security in Transcaucasia", Army War College Strategic Studies Institute, September 1994, pp. 1-2.

Union. The U.S. had appropriated $2.5 billion in aid to the former Soviet Union for fiscal year 1994, but only $1.05 billion had been designated for transfer by mid 1994. The funds, of which 20 percent was earmarked specifically to the economic sector, were divided as follows within the energy sector: $80 million for energy efficiency - to improve the efficiency and extend the privatization of energy production and to increase safety at Soviet-style nuclear power plants; and $125 million for energy and environmental imports - to provide financing for Russian importers of U.S. equipment to improve energy production and reduce pollution, especially in gas production. This is only a token of support compared to that which was allocated in the late 1980's for agricultural subsidies and Perestroika reform. The designated funds are not sufficient for the problem at hand, and secondly, why has $1.45 billion been held back with out any reference to future allocations? Much of the controversy is directly related to the lack of support for FSU aid on Capitol Hill by both the ranking Republicans and Democrats[111]. Most lawmakers focus on the lack of reform and the policy proposals set forth by Strobe Talbott, architect of the Clinton administrations policy toward the former Soviet Union. Mismanagement of 1994's $2.5 billion aid package by the Yeltsin Administration is also a major concern from both parties.

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[111]"How U.S. Aid to Former Soviet States is Spent", Congressional Quarterly, January 29, 1994, pp. 187-188.

Currently, this jeopardizes the 1995 $900 million aid package proposal to the former Soviet Union.

There is no simple answer but the necessity for bipartisan support is crucial for the future allocations of indispensable U.S. aid to the CIS. The key concern for many politicians is the fact that the Clinton administration has paid too little attention to the non-Russian former Soviet republics. The policy by the administration has been "Moscow first, Yeltsin right-or-wrong approach" as suggested by Mitch McConnell (R-KY), ranking Republican on the Senate Foreign Operations Appropriations Subcommittee[112]. This appears to be the attitude taken by a majority of the Republicans. The problem stems from a lack of careful delineation of what aid is in the U.S. national interest. Once this dilemma is solved, the necessary economic prosperity for both the U.S. and the FSU can get off to a future of mutual benefits for all parties.

The role of oil and gas from the former Soviet Union will be lost if expedient action is not taken within the next couple of years. The U.S. has the resources, technology, capital, and transnational oil companies available to lend the support. The oil-producing states of the CIS are not in a position to bolster their respective energy economies from state or private capital. With the continued plummeting of oil and gas export revenues, the availability of capital reinvestment is also dwindling. It is

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[112]Carrol J. Doherty, "Anger Gives Way to Caution in Debate over Russia Aid", Congressional Quarterly, March 5, 1994 p. 556.

time for the U.S. to step up and prove its humanitarian efforts in the world are not a facade. This can only be achieved through the establishment of a world order which places more emphasis on interdependency and mutual cooperation. This would also prove to Russia that the U.S.'s Cold War efforts of providing genuine assistance for humanitarian efforts was not utilized to counter communist influence but to provide indiscriminate humanitarian assistance to all mankind.

C. UNITED STATES' INCREASING DEPENDENCE ON FOREIGN OIL

Energy consumption in the United States for per capita consumption is twice as high as that for any of our industrial competitors. This explains much when considering why the United States currently depends on over 50% of its domestic consumption of oil from foreign sources. With the dramatic drop in domestic production and the more lax policies for energy conservation since the 1970's, it is no surprise that the United States is setting itself up for a devastating national security crisis. The conventional wisdom of our congressmen, president, and the Department of Energy has been naive and self-serving at best. The few policies initiated (e.g., Strobe Talbott's policy for placing emphasis on Russian energy) by the United States' during the Clinton administration have been too few and fail to emphasize the implications for our national interest.

For example, the new strategic plan for the United States' energy sector published by the Department of Energy(DOE) fails to address the importance of securing energy supplies until new

technology can replace oil and gas as a primary source of energy with respect to national security[113]. The main DOE emphasis for national security interests entails preventing the spread of nuclear weapons, guarding the current nuclear technology, reducing the worldwide stockpile of nuclear weapons, and enhancing energy technology infrastructure. These areas of interest are all very important, but national security emphasis on nuclear weapons is not the only critical area of concern. Current dependence on foreign petroleum requires a policy that considers supplementary supplies from more than one source. This lack of concern for a more grandiose policy greatly affects the future of our foreign policy relevant to petroleum security.

The National Energy Strategy implemented by the Bush administration following the Persian Gulf War was an appropriate response to the United States energy dependency. The problem with this strategy was the fact that it addressed critical areas such as foreign oil but neglected to implement policies which would modify perpetuating practices of importing more oil and gas from the Middle East. Between a blatant disregard for environmental conservation practices and the inability to foresee (and admit) the impending energy dependency status of the United States, the leaders of our nation decided to ignore the telltale signs until a crisis was at hand. For the sake of the United States' future energy security, crisis management should not be a

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[113]See U.S. Department of Energy's Strategic Plan for April 1994, pp. 20-23.

common practice as past events will dictate. Future petroleum crises will be much more severe. No one can foresee the possible damage to national security but the possibility for economic paralysis is extremely plausible.

D. IMPLICATIONS FOR UNITED STATES' INVESTMENT IN RUSSIAN PETROLEUM

The United States must be willing to take a risk when contemplating the position of Russia within the future world order. No matter where Russia shifts within the political spectrum, it is evident from a historical perspective that Russia will be a key player.

The disorderly policy employed by Moscow to gain control of the Russian petroleum sector is ineffective and lacks the resources necessary for successful reformation. At this critical juncture in U.S./Russian relations, it is time for Washington to step up the pressure on Moscow to cooperate with the West with respect to economic development. Foreign aid is still a major necessity for Russian economic recovery. It should be the main carrot of choice when considering Russian cooperation. The nature of current cooperation places too much emphasis on political orientation and the rate of change respective of democratic principles of organization. A democratic state is not built over night. The future of Russia is not dependent upon whether Russia will become a democratic state, but whether they have been offered the financial and personnel aid necessary to transform into a democratic state. The final outcome will depend upon which ideology is supported by the major political

institutions and the realization of a dire need to reform the old practices of waste, coercion, and graft. The choice will most likely depend upon the resources available and the public support, provided free elections are still the norm.

The Russian petroleum sector has a great deal to do with economic recovery. As stated prior, foreign capital is the key to building infrastructure, expanding modernization, and attracting foreign technology. Since Russia depends on petroleum for over 60 percent of its foreign export revenues, reform is directly related to these exports.

The implications for United States' investment in the Russian petroleum sector involves many risks but even more benefits. If the United States can help Russia while systematically fostering a more stable world order and economic security at home, then the choice of involvement within the Russian petroleum sector is a question of risk assessment. How much risk is the United States willing to take in order to ensure economic security and ultimately national security? This question implies that it is within the United States' national interest to consider such a policy.

The risks involved with Russian investment include: (1) the possibility of Russia shifting to the nationalist right which would involve a situation much similar to the pre-Gorbachev Soviet Union; (2) the corruption of foreign aid to be use for other than designated purposes; (3) transnational oil companies investing in exploration and infrastructure without guaranteed

returns; (4) Moscow changing laws which inable them to renege on oil contracts and/or passage of presidential decrees which discriminate against transnational corporations. These do not encompass all possible risks but pose the more serious dilemmas for the governments and transnational corporations willing to take that chance.

Russia is a place where caveat emptor is one of the first investment rules. This is primarily due to a complete absence of security of title in the legal sense[114]. The financial infrastructure is primitive. Unlike other emerging market countries, the custodial system for the registration of stock certificates is not in place. There is no central registry of shares, therefore, foreign companies must keep their own registries. Several foreign oil companies have encountered this problem without the availability to seek retribution for lost capital. The result has been a complete dissolution of investment.

Aside from the risk, U.S. foreign aid and encouragement of transnational oil corporation investment have the potential for massive payoffs financially and in terms of national security. The most prominent economic agreement to date for the United States/Russian cooperation is the 'Partnership for Economic Progress' which was signed by President Bill Clinton and

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[114]Christopher Wood, "Destined to be Rich", Forbes, Volume 154, Number 8, October 10, 1994, p. 48.

President Boris Yeltsin in October, 1994[115]. This partnership sets out the agenda for greater trade interaction between the two countries. The main emphasis was the removal of major barriers to trade and investment. The U.S. decided to immediately transfer $100 million in aid funds to directly support trade and investment through the U.S. Commerce Department. This agreement is a great step towards mutual cooperation but does not go far enough. The U.S. must be willing to commit the necessary capital, technology, and human resources in order to revamp the Russian economy to at least simulate a market economy. The initial step will be a commitment respective of the rhetoric from the National Energy Policy under the Bush administration.

This National Energy Policy identified goals of increasing oil production outside the Persian Gulf by promoting greater involvement of American companies within Russia. The policy stressed the need for transferring Western equipment and technology, especially recognizing the expertise of American companies in the oil and gas industry. The Office of Export Assistance was established to provide the necessary focus on energy related exports. This office was responsible for working closely with the Office of International Affairs, the Departments of Energy, State, and Commerce, to coordinate activities within the U.S. government to promote exports and ensure that the energy industry received the appropriate level of government support.

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[115]Richard Seltzer, "U.S. - Russia Summit Spurs Trade and Investment", Chemical and Engineering News, Volume 72, Number 40, October 3, 1994, p. 7.

What has happen to this policy which would directly support the U.S. energy sector? Apparently, as mentioned earlier, the congressional support seems to have focused on internal energy matters instead of the more important energy matters of foreign investment and external national security concerns. This focus must change if the United States has any plans for exploiting the opportunities available in the former Soviet Union.

The United States has the ways and the means to capitalize on the misfortune of the former Soviet Union. This is not a decision to exploit the misfortune of others but to benefit from economic windfall (Russian petroleum turmoil) for future security. The Russian energy prospects will not be a gift served to the U.S. on a silver platter, rather with the necessary investment and desire to establish a stable and prosperous Russian economy, the silver platter may be seen in the future as massive dividends from petroleum partnerships, a stable political economy within the former Soviet Union, American energy imports from more diversified sources, and ultimately a more stable supply of cheaper world petroleum in support of the U.S. national interest.

V. RUSSIAN ECONOMIC SECURITY IN THE TWENTY-FIRST CENTURY

A. BURDENS OF THE PAST AND BUREAUCRATIC LIMITATIONS TO CHANGE

Throughout the Soviet period, the main impetus of the petroleum industry was to be a supporting mechanism for the massive military industrial complex. During this era, efficiency was displaced for mass petroleum output. Petroleum output, unlike the output of today, was controlled by a command economy under strict bureaucratic controls. The introduction of privatization after the 1991 demise of the Soviet Union created an atmosphere of hope and revitalization for the petroleum industry. The major problem, besides the lack of sufficient cash flow, has been the political uncertainty which continues to preclude true reform. The economic and political stability necessary for a prosperous petroleum industry can only be achieved through further privatization of the industry.

This milestone has been partially accomplished despite the vacillating efforts of Boris Yeltsin. On April 1, 1995, he hesitantly signed a long-awaited decree which would overhaul the Russian petroleum industry. This decree calls for the full corporate merger of subsidiary companies into Russia's huge oil conglomerates (e.g., Lukoil) and mandates the privatization of the government-owned oil giant, Roseneft[116]. In addition, Yeltsin signed another decree in late April, 1995, which removed a major

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[116]Neela Banerjee, "Oil Industry Overhaul is Ordered by Yeltsin, but Questions Remain", The Wall Street Journal, April 4, 1995, p. 16.

hurdle blocking the disbursement of nearly $1.4 billion in commercial loans backed by the U.S. Export-Import Bank to Russian oil companies. This decree lifts a requirement that oil exporters convert 50 percent of their hard-currency to rubles[117]. In effect, this policy was supposed to boost the value of the ruble but never materialized after the demise of the Soviet Union.

As we look into the future, a whole host of problems may affect the solvency of Russia's economic turmoil. However, the issue should not be placing trust in one political figure such as Boris Yeltsin, but rather a more comprehensive approach of initiating institutional reform through direct monetary and personnel assistance. By focusing on personalities, we fail to see the power center from which real change can be manifested.

The old Soviet Union clearly possessed a distinct chain of command held together by the Communist Party apparatus. Today, the structure which bonded these institutions (e.g., the KGB, Armed Forces, military industrial complex, state bureaucracy, etc.) has disintegrated. That which is left of any organizational structure is controlled through the bureaucratic and traditional way of thinking. The current power structure in Russia is controlled by the successors to the aforementioned institutions which have also become more autonomous than before. These institutions now enjoy a negative power structure whereby

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[117]"Hurdles Removed on Loans to Russian Oil Companies, The Wall Street Journal, May 2, 1995, p. 15.

their objectives are not clearly delineated through a constitutional process which also explains the weak legal system and the lack of reform. These institutions do possess enough power to dilute, sabotage, and derail the projects of others, but not enough power to implement reform thorough legal processes.

The legacies from empire to include old institutions, old elites, and old habits of mind are extremely difficult to root out. There are five main areas comprised of the multinational structure, the economy, the defense complex, the KGB, and the Russian Army, which have created the most extensive problems from past experience[118]. For this study, I have focused on the economy since the petroleum industry is a mirror image of the economic market conditions.

Gorbachev lobbied to save the single economic space during the late 1980's, but the interest quickly disintegrated towards isolationism and nationalism. The Communist Party and the union center were the only political forces resisting disintegration. The economy was faltering and the discredit by historical experiences to reverse the change was not on their side. The result of the disintegration was a complete collapse of the Communist regime. The Soviet Union as we know it, ceased to exist. The Soviet republics transformed into independent states (mostly), but they could not survive economically without the

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[118]James Sherr, "Russian Orthodoxies", The National Interest, Winter 1992/93, pp. 43-44.

others. The contributions received from the center was now nullified.

The contiguous step for the center (the Moscow bureaucracy) was to modify the status quo by introducing economic laws which would create a democratic process of electing directors to the newly created Council of Labor Collectives (a council responsible for economic objectives between all states). These actions attempted to produce democratic principles in the economic sphere vice the political sphere. Budget restraints completely disappeared, consequently, enterprises became largely more independent.

The voluntary enterprise associations were created as an additional link towards economic cooperation. Most enterprises joined in fear of losing cooperative links with various governments and institutions. Due to the pressure from the republics, Moscow decided to decentralize economic sectors such as construction, agriculture, and processing industry. The union government also accepted the idea of regional and republican khozraschet (self sufficiency), first promoted by Estonia.

The period of perestroika stressed accelerated growth and institutional and individual discipline. The growth rate increased machine building and many manufactured products. Many of the problems from this era stemmed from what Gorbachev mentioned in a speech from 17 May 1990, "The problem with the Soviet Union is the people's conservative way of thinking, their dogmatism . . . changing peoples minds is the most difficult

thing. Perestroika depends on public opinion"[119]. An anti-alcohol campaign during this era was also a hallmark. The strategy followed the concept that institutions and people needed to be more productive. This could actually be referred to as a Leninist approach. Greater openness (Glasnost) was to encourage accountability and responsibility with the streamlining of old institutions[120].

During perestroika, the leadership stressed the following themes: democratization, marketization, modernization and integration into the world economy. The environment required for such a comprehensive reform would include arms control, regional crisis resolution, and increased assistance from the West. Democratization was based on the establishment of pluralistic government, laws for institutions which were responsive to market forces, will of the people, enhanced authority for parliamentary institutions, and mobility based on performance. Marketization was based on monetary stabilization followed by price reform. This would require market reports to measure the criteria for economic activity. Markets for capital would be produced along with monopoly control. Markets were created for capital, labor, and an outlet for goods. The rapid privatization of production was a necessity but disregarded for a gradual implementation.

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[119]Ian Jeffries, Socialist Economies and the Transition to the Market, (New York: Routledge Publishing, 1993), p. 39.

[120]Reiner Weichhardt, The Central and East European Economies in the 1990's: Prospects and Restraints, (Brussels: NATO Economics Directorate and Office of Information and Press, 1990), p. 18.

Integration into the world economy included expansion of trade, opening industry to foreign investment, participation in international economic institutions, establishment of meaningful exchange rates, and achievement of currency convertibility. Modernization included replacement of low productivity enterprises with more efficient enterprises with the capacity for competition in the world market. This process would also include changes in the structure of investment and production (including conversion of defense production).

The Russians declared sovereignty (1990-91) and commenced campaigning for a transfer of enterprises under union control into its own possession. Under turmoil, the collapse of the centralized government was quite evident. Upon the destruction of the old system, there appeared no network of market economic relations. Fifteen new independent command systems appeared with only partial complimentary market structures. It was time to open the doors to private sector development. The problem was as follows: what would be the avenue for relinquishing authority away from the state sector? The state continued to have primary control and access to all resources. The economy was headed towards disintegration and anarchy.

The consequences of this union disintegration included: loss of control over wages, accelerated growth of income of population, and a drastic fall in production. The dissolution of traditional economic links between the independent states posed problems of maintaining existing levels of production. During

this time, state investment declined due to a battle against mounting financial crisis. Ultimately, the planning system collapsed and reform was required in epic proportions.

The single system consisting of one body of control and implementation was now little more than fragments. Each entity had lost its prior compatibility with one another. Since the disappearance of the center, bilateral agreements on deliveries and price control would have to assimilate common regulations. Progress was slow and painful. Each state looked towards its own interest, and nobody trusted one another.

The financial system has created the problems of accelerated destruction of the economy. The many routes available in creating a new cooperative economic system are labeled futile by those who destroyed the infrastructure. One critical view of the collapse of the communist regime blames the sector leadership for total disregard of financial problems. If these leaders had directed more attention to the financial and monetary policies, the Soviet Union would probably still exist as a bona fide economic institution. "Softer institutional changes" may have preserved the socialist economy of choice. Since the commencement of Perestroika, financial policy of the union government had been irresponsible and controlled through populism. Communist control inevitably lost the trust of the people.

The Soviet Union needed a policy which granted independence and privatization of state enterprises along with price

liberalization and budget constraints. Apparently, liberalization of personal incomes was initiated as a substitute for a bona fide taxation system. Consequently, state expenditures and state budget deficits grew out of control. The deficit was accepted by the union, but revenues were re-distributed to republic and local governments. Due to the unsuccessful reconstruction of the banking system and credit policy, total control of money (capital) supply was lost. The budget deficit was financed from the GOSBANK, which in turn, took credit away from the rest of the deteriorating economy. In 1991, the union and republic governments deteriorated due to the struggle for budget reform.

The ruble was immediately devalued from the loss of financial stability and caused a direct fall in production. The separate budgets of fifteen states operated with lack of agreement and endangered those stabilization policies already implemented by the Russian government.

A very costly mistake made during perestroika was in the area of external economic and exchange rate policy. A principle referred to as "foreign exchange self-financing" was utilized to commercialize the state enterprises on the way towards privatization. Self-financing referred to the foreign exchange allowed to remain within the state. The states whose economies were largely dependent on imports were required to earn foreign exchange. The states that primarily exported products were much better off financially. The flaws of this policy could have been

corrected if the enterprises were forced to buy foreign exchange at the current market rate, just as the case in western capitalist states[121].

The decline in production negatively impacted the oil and gas industry (major export items) which was the most important source of hard currency revenue. The western nations ceased to observe Russia (CIS) as a reliable debtor. Most enterprises avoided export taxes by leaving their earned exchange in western bank accounts or conducting only barter deals. The rules of the game changed and now the only strategy was survival.

The Russian Federation continues to create change in their economy. With the assistance from the G-7 nations, reform will hopefully take the initial steps towards a market economy. Currently, a lack of international trade has stagnated the economy. The changes need to develop vigorously and with careful consideration of the long term consequences.

The fifteen newly independent states presently have observed sharp declines in interstate trade and trade with the rest of the world. International requirements for hard currency are financial burdens among the states. The drop in trade volume causes a decrease in production and decline of incomes. The effects of negative trade has multiplicative results to numerous internal trade mechanisms. The access to new markets is essential for survival in the market economy.

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[121]Weichhardt, pp. 18-30.

International exports have decreased fifty percent in the last two years. Government controls on exports (licensing, quotas, taxes, surrender of foreign exchange at less than market prices) discourages most states to export. This has led to "illegal" exports and trans-shipments of raw materials and oil by "under invoicing" exports and by "over invoicing" imports. The market rate of foreign exchange is low relative to purchasing power. This provides increased protection against hard currency imports.

Inflation and loss of control within the ruble zone force most states to pay for imports with rubles of declining value. Central banks within the ruble zone have extended credit on exports to enterprises, but the credit was cut at specified limits in order to control the flow of goods between states. The flow of imports of energy and raw material from Russia into the independent states has created a situation of dependence. Most states are attempting to avoid this situation due to past experience. Once export restraints are reduced and the ruble zone defined, the economy should be able to internationalize trade and increase imports and exports.

Price liberalization is currently a problem for a majority of products. Energy and raw materials are priced well below the world market level. These products are under very tight export control between world markets and states within the ruble area. Bilateral trade agreements have greatly increased and still possess many features found in programs from the old central

planning government. The use of price control and product deliveries also fall under this system.

The Russian Federation is gradually moving trade transactions toward market prices. This causes many problems for those states which import much of their energy sources. Energy and fuel was a cheap trade commodity while the Soviet Union was still a nation state. The only countries who stand to gain in fuel and raw material are the exporters from Russia, Turkmenistan, Kazakhstan, and Azerbaidzhan[122].

The market economy within the Russian Federation will most likely produce bankruptcy for many enterprises. Many economists assert that this process is necessary in order to derogue those industries not capable of withstanding reform. Most of these enterprises were extremely weak prior to the conversion process. Some weak enterprises will flourish (as producers), if the tax burden is decreased, and the strong enterprises incorporate the weak ones into the fragile economy. The production process in real commercial goods must increase exponentially before the trade process can flourish. This is why the economy needs to push the producer to the forefront of the economy.

The banking system is currently hindered by inflation. Some loan rates are as high as 200%. With these type of rates, bankruptcy will be widespread, and the banks will own the

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[122]Constantine Michalopoulos, "Trade Issues in the New Independent States" in Studies of Economies in Transformation, Washington D.C., 1993 by The World Bank (Washington D.C.: The World Bank, 1993) p. 3.

enterprises before long. The banks do not have the business experience to operate the industries; thus, the disintegration of the economy would repeat once again.

The situation in the Russian Federation for the year of 1995 (projected by the Russian Ministry of Finance) shows the budget deficit to reach 10.5 percent of GDP. Inflation will average 7 to 9 percent per month. The market exchange rate is 7000-8000 rubles to the dollar. The decline in industrial production should reach no more than 6 percent and 3.80 percent for agra-industrial production[123]. The situation is still waning, but the adoption of the Russian Federation Constitution which created the preconditions for the continuation and development of economic reform is continuing to create headway.

The Russian Federation is concentrating efforts on pursuing a moderately tough monetary-credit policy, continuing the process of privatization, implementing a package of measures to provide the population with social support, broadening the autonomy of the regions, carrying out institutional transformations, developing relations with the CIS member states, and further liberalizing foreign economic activity. However, various important tasks in the socioeconomic sphere have not been accomplished to include: decline in industrial and agricultural production, stoppages at enterprises, continued financial crisis, marked drop in investment activity, the preservation of an

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[123]"The Path of Economic Development", FBIS - Central Eurasia, Moscow, March 24, 1995, p. 4.

irrational national economic structure, and a noticeable drop in the standard of living for most people. The government is concerned with problems linked with the untimely payment of wages, deterioration in enterprise's solvency, the continuing high level of inflation, and the increase in crime. The Russian Ministry of Finance acting jointly with the Central Bank of Russia is currently working on a plan to draw spare cash from corporate entities, corporate banks and the population, for the investment in the production of goods and services. The Russian Federation is also establishing numerous laws and regulations to ensure the adequacy and implementation of necessary sector flows of economic reform. The government currently accepts the need for expedient reform and the enforcement of regulation.

Russia must keep close economic links between each of the CIS states for possible future success. Economic prevalence will only be achieved after the needs of the economy, needs of the people, and the creation of new jobs is integrated within all aspects of the Russian economy. The CIS is currently not productive in the international market. The only exception is energy and raw materials which is limited to specified states. In order to preserve the single economic space, all the former republics need to open up markets through one another and create an unified export base. This will also require the abolition of many explicit and implicit export restraints.

The factors which have contributed to the economic decline of the fifteen new independent states are paramount. The

following approaches should ensure the restoration of trade relations with each other and integrate their economies with the broader international economy. The former Soviet states should adhere to some of the recommendations suggested by Constantine Michalopoulos (World Bank):

> *(1) Phase out price controls, related export restraints, and import subsidies; (2) strengthen competitive forces by terminating state trading, promote entry of private firms, and encourage enterprise-to-enterprise trade; (3) improve institutional infrastructure in support of trade relative to domestic and international payments system; (4) increase intergovernmental cooperation on trade and payments issues; (5) international community should provide technical assistance and policy advice for CIS trade internationally; (6) international community should improve access for exports by reducing their trade barriers on imports of manufactures and agricultural products*[124].

The obstructions to free markets within Russia correspond directly to the "old" Soviet bureaucracy which is attempting to dismantle the old command structures. When local bureaucrats obstruct rather than assist in the process of economic reform, the center responds by strengthening the power of the center as was the case during the Soviet era. Currently, there exists conditions of anarchy unlike the Soviet-style centralization. Where ministries have disintegrated, local legislative bodies have rushed in to issue decrees, export licenses, and the registration and authorization documents entitling enterprises to

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[124]Constantine Michalopoulos, "Trade Issues in the New Independent States" in Studies of Economies in Transformation, Washington, D.C., 1993, by the World Bank (Washington, D.C.: The World Bank, 1993), p. 3

be "in business"[125]. The result is an extremely corrupt corporate system. With a corresponding (and in kind) response from the center to issue decrees (by Yeltsin), the result is likewise a corrupt political agenda (e.g., excessive export controls in order to limit capital flight).

The petroleum sector is no different, perhaps even more corrupt due to the massive funds at stake. The petroleum enterprises pay virtually no taxes. They are treated as "pet projects" by the Yeltsin Administration unlike the other private industries which must over-compensate from "the lack of petroleum taxes" (quite the opposite as noted earlier for the joint ventures). As can be inferred from the forthcoming examples, capitalism under Russian terms bolsters individual enrichment through a process of quid pro quo. If the oil and gas industry was treated like other private industries (e.g., taxes and legal code), it could contribute about 10 percent of Russia's gross domestic product or up to $30 billion in tax revenues. A prime example of corrupt behavior in the petroleum sector is the practice of keeping oil and gas prices artificially low within the FSU (e.g., December 1994 domestic price was 25 percent of the world market price)[126]. This practice was initially enacted in order to offset high transport costs and keep industrial

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[125] James Sherr, "Russian Orthodoxies", The National Interest, Winter 1992/93, p. 44.

[126]Anders Aslund, "How Russia Became A Market Economy", Carnegie Endowment for International Peace, New York, 1995, p. 13.

production costs under control. Additionally, inadequate export controls allow oil executives to sell oil on their personal account abroad. They are able to buy the oil at home for four times less than the world price, then turn about and sell it abroad at the global level. The interests of the petroleum industry are well protected but unfortunately it is at the cost of real reform. These inexcusable acts of self preservation can only mean the continued disintegration of the state. Prolonged corruption within Russia's energy sector will threaten democracy and stability without conciliatory action by the Yeltsin Administration. This action must come in the form of legal reform, political cooperation, will power, and ultimately pragmatic assistance from the West.

B. RUSSIAN ECONOMIC SECURITY AND WESTERN AID

The lack of real and substantial aid to Russia from the West had been much less significant during the Soviet era than since the demise of Soviet Union in August, 1991. The most irrational response of Western governments to the economic and political transformation in Russia and the rest of the FSU has been their unwillingness to make any major commitment. The United States and Germany headed two international meetings in 1992 to provide humanitarian assistance to the FSU. This form of aid at the time did not appear appropriate since there existed no humanitarian emergency in the entire FSU. Humanitarian aid was most likely substituted for real structural assistance and systemic change which would promote macroeconomic stabilization. This aid was

promoted most likely due to the fact that humanitarian aid is cheap and generates good publicity. It is evident from their response that Western governments did not take the Russian attempt at economic transformation seriously.

To put this in a historical perspective, the Western behavior at this time is reminiscent of the period after World War I. There was no single nation which took initiative and international responsibility for the consequences of the future viability of the international community. Each nation was more interested in its exclusive national interest without the necessary consideration of whether the stability of the international community was still a significant concern. With respect to the Soviet demise, the pragmatic and idealistic views from the days of the Marshall Plan are completely absent. Take for example during the apex of the Marshall Plan (1948-49), U.S. donations totaled 2.10 percent of U.S. GDP; for 1995, the U.S. budget request for aid to the whole FSU amounts to 0.01 percent of GDP[127]. The differential is quite apparent and substantial. We can speculate in view of the U.S. perspective that the rebuilding of Europe after World War II was much more important than the restructuring of Eastern Europe, Russia, and the rest of the states of the FSU, after the end of the Cold War. This does not say much for the Western politicians' vision for the future of the international community.

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[127]Aslund, pp. 216-220.

Why was the West (and specifically the U.S.) lax in its response to such a landmark event of the fall of the Soviet empire? It is understandable that the West would proceed with extreme caution, but isolating the Western alliance against the possibility of influencing the political and economic liberalization of the Russian states was not much more than a remote consideration. No one in the West displayed appropriate international leadership. Therefore, the IMF, which was tasked with the disbursement and allocation of various funds to the FSU, gained more prominence in the post-Soviet transition than it had the capacity for. It can be suggested from these events that the collapse of the Soviet Union was not dramatic enough for the world community to realize that a fundamental postwar crisis would ensue in the aftermath. The current isolation of the Russian state can be attributed to the inappropriate response by the West of treating the Russian Federation as a rogue state instead of one of the most powerful military and political states in the world. In essence, Russia must be strong enough to endure the lack of international political support and set its sights on the private international sector which can prove to be the most crucial asset to a prosperous future Russian state.

The West is having a difficult time trying to determine whether Russia will be a partner or emerge again as a rival. This is one of the major dilemmas which has precluded the expansion of aid and investment in the Russian revolutionary transformation. Would a decrease of Western involvement create a

self-fulfilling prophecy by making negative assessments about their future? Russia has managed very well to cast off the old communist system on its way towards democracy and capitalism. The question still remains whether the West is willing to commit enormous resources in order to influence the course of history for Russia in the twenty-first century.

With all prior Western responses set aside, Russia and the world desire a successful transformation of the FSU into bona fide democratic states. Foreign investment must occur at a much more rapid pace in order to promote stability in a current state of confusion. Russia must ensure an investment climate conducive to foreign investment. This is especially true within the petroleum sector because it is the primary driving force able to kindle economic growth. As mentioned earlier, President Boris Yeltsin has incorporated many investment incentives into the Russian emerging market, but the political and economic uncertainty still prevents many prospective investors from taking the initial risk. So far, Russia has failed to bridge the gap on basic business principles which are fundamental to mutual success. It is imperative that Western investors and Russian public and private business representatives seek a common understanding through seminars and other information exchange programs[128].

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[128]Constantine S. Nicandros, "Russian Oil, Western Investment", Royal Institute of International Affairs, London, England, July 1, 1993, p. 756.

It is quite apparent at this time that the large Western oil conglomerates view Russia and the FSU as one of the greatest potential oil and gas regions in the world. Take for instance the gamble by Exxon Corp., Mitsubishi Corp., and China's state oil company, to contemplate a partnership to build a $12 billion, 4900 mile natural gas pipeline from the former Soviet republic of Turkmenistan, on the Caspian Sea, to the Pacific Ocean outlet in China. This proposed partnership would tap the large petroleum deposits in the Caspian[129]. With such a partnership, the Russian Federation would be bypassed for any passage rights and/or royalty payments. The following proposal may seem unrealistic, but in view of the current Russian restrictions on most petroleum extracted within the confines of the former Soviet Union and transported across its territory, the possibility for the execution of this proposal suggests the desperate attempts by foreign oil companies to bypass Moscow for an expedient share in the FSU petroleum trade. Money appears not to be a concern when the risk can be divided into smaller portions and even greater returns.

The barriers imposed by the political actors (and including culturally inherent barriers) pose serious risks to the future survival of the Russian economy. There is a lack of clear delineation of responsibility among Russian decision-makers which makes it very hard to make progress in negotiations. There is no

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[129]Steve Levine, "Exxon Eyes Big Gamble", San Jose Mercury News, September 9, 1995, p. 1A.

defined tax code, and multitudes of taxes are being invented by different entities, which if actually imposed would exceed total revenues. Another barrier is the wide chasm in cultures. Russians and Westerners are taught to think in different ways and uphold different value systems. There does not appear to be any common understanding when in it comes to business dealings[130]. Mutual trust as in the past is in short supply. The answer lies somewhere in the process of mutual and shared risks between the private and public sectors, and the increased utilization of common business protocol.

There appears to be three main barriers which obstruct the acceleration of international investment momentum. They are as follows: (1) a lack of a common frame of reference (e.g., the concepts of profit, return on investment, cost efficiency, and a common business vocabulary); (2) the tendency to spread resources too thin (this includes most of the Western aid promised to Russia which has the potential to be spread too thin and have no realistic effect); and (3) the lack of adequate risk sharing mechanisms (Russia desires the financial burden be placed on the transnational petroleum companies).

The priority must be to focus on these three areas and finding ways around them. The only way to approach these setbacks is by learning to work together. Western petroleum companies need to find expertise within the Russian workforce and

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[130]Constantine S. Nicandros, "Russian Oil, Western Investment", Royal Institute of International Affairs, London, England, July 1, 1993, p. 756.

complement this with their own. Conoco and various other petroleum companies have attempted to confront these problems by joining forces with Russian research institutes and by creating a data base of all the organizations in the FSU that can provide goods and services for the petroleum industry[131]. This measure alone will not solve the unique problems at hand, but it is a significant start towards finding a common ground.

Unique circumstances and unique risks associated with the failure of reform in Russia justify some extraordinary effort. This effort will not be attainable unless both Russia and the West are willing to make concessions in order to incorporate the business culture of both sides. In the end though, Russia is the only player that can replace the present disarray in the legislative and tax codes with rational and efficient structures. The onus will ultimately fall upon the Russian Federation and its future cadre of political leaders. The transformation of Russia into a future economic power and reliable trading partner will be difficult if not daunting, but it will prevail if everyone works together with an esprit de corps, a common purpose, and sheer determination.

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[131]Nicandros, pp. 756-757.

VI. CONCLUSION

The Soviet Union had been many things to many people to include ethnic groups, leaders, military personnel and adversaries. That state has ceased to exist as a political and economic entity. Today, the dawning of a new era for this region is at an early stage where political and economic trends have not yet been established. Preliminary indications as suggested in this thesis point to major economic changes which statistically appear hopeful but still influenced through political corruption from the Soviet era. The parliamentary elections this fall (1995) and the presidential election of 1996 will most likely determine the direction of Russia in the near future. This decision will ultimately be determined by the political elite's ability or inability to fulfill the needs of an impatient public.

The petroleum industry in relation to economic prosperity should be quite apparent from the emphasis placed upon the industry from both Russia and foreign petroleum corporations. The question of whether confidence-building measures necessary for continued economic opportunity have been introduced by the Yeltsin administration is still not apparent. Much of the evidence presented in this thesis suggests that there is still considerable risk that the economy could go awry again, but such a pessimistic outlook can only lead to further isolation of the Russian Federation from the rest of the world. States which comprise the G-7 (who have the most clout in worldly affairs) must ensure this does not happen due to the dire consequences of

an unstable and isolated Russian state. Western complacency has already done serious damage to this region (e.g., lack of financial aid and personnel assistance in the privatization process), but the consequences are not irreversible if expedient action is taken in the very near future.

The facts presented within this thesis emphasize the significance of the Russian petroleum industry both within the FSU and its implications for the world and particularly the United States. Conclusions can be drawn from these facts that include the following: there is a slim possibility of Russia solving the inadequacy of its petroleum industry without Western assistance; political instability will continue to deteriorate without legal and constitutional reform; political instability will create economic turmoil and ultimately further deterioration of the petroleum industry; the prospects for newly discovered petroleum deposits appear promising provided necessary capital is available for extraction and pipeline construction; and finally, Russia must be willing to work in cooperation with the other independent states in order to secure a successful commonwealth.

In order to put this all in perspective and explain the significance of the role of the Russian petroleum industry, we must contemplate a recent development where Russia lined up collateral stock to secure new loans. The Russian government has listed twenty-nine companies in which state-owned shares will be used as collateral to secure loans to the federal government. At the top of this list, oil giants Lukoil, Yukos, Surgutneftegas,

and oil trader Nafta Moskva, compose a majority of the intended stock transfer. A presidential decree signed on August 31, 1995, allows the government to turn over its holdings in the companies to lenders in return for loans. Certain restrictions will apply to the oil companies' shares sold to foreign investors. These stipulations have not been determined, but the decree also states that once the loans are paid off, the investors will sell the shares and receive an undisclosed commission from the Russian government. The Yeltsin administration hopes to raise at least 3.00 trillion rubles ($672 million) from this process for the Russian budget in 1996. This money will be utilized to meet the target budget of 8.70 trillion rubles for the privatization process and economic revitalization. This appears to be a positive step for the Russian economy, for the Russian petroleum industry, and for Western investors to get a foothold within the Russian petroleum industry[132].

In order for Russia to attract the necessary foreign investment, more energy roundtables must be held (similar to the one held in July 1993 mentioned earlier) between foreign investors, Western governments, the Russian government, and the governments of the oil-producing states of the former Soviet Union. The major obstacles (e.g., tax codes, royalties, pipelines, capital investment, etc.) must be addressed in a forum with equal representation and a mutually-agreed upon agenda.

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[132]"Russia Lines Up Collateral Stock to Secure Loans", The Wall Street Journal, September 26, 1995, p. A-19.

Initially, there must be a comprehensive legal framework covering the broad array of private business activity. This can only be accomplished after compromises have been made by all sides. This process will be similar to the negotiations accomplished by the U.S. during the NAFTA discussions. Stability must be a prerequisite within the large Russian industries and corporations (especially the petroleum industry) in order to facilitate stability within the entire economy.

The cloak of stability within Russia will entice those transnational companies formerly intimidated by political and economic uncertainty. Stability is by no means the answer to success for Western investment, but it is one of the initial building blocks for expanded investment and the cornerstone of confidence-building measures. The petroleum industry as indicated throughout this thesis is the pathway from which hard currency can be earned and invested within the economy and should eventually equalize the diversity of wealth and income found between exporting industries and those industries which produce exclusively for the internal markets.

Ultimately, the petroleum industry and the Russian economy must work in tandem to overcome the various political and social barriers placed upon them by the residual effects of the Soviet system. Many of these problems are created by the reluctance of the various political actors to adopt real structural change for fear of the uncertain consequences. Fear of the unknown will more than likely leave the former Soviet Union in a "muddling

through" phase of perceived reform, unless the structural changes as discussed in this thesis are institutionally incorporated within a legal framework and accepted by the business community as common practice. The Russian petroleum industry will have the potential to tremendously influence the world petroleum market provided this industry is perceived by the political elite of Moscow as an indispensable asset for the world market and the future of Russian economic stability.

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